FINAL TRANSCRIPT

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GGG - Q1 2010 Graco Earnings Conference Call

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PRESENTATION

Operator

Good morning, and welcome to the first quarter 2010 conference call for Graco Inc. If you wish to access the replay for this call, you may do so by dialing 1(800) 406-7325 within the United States or Canada. The dial-in number for International callers is (303) 590-3030. The conference ID number is 4282472. The replay will be available through April 27, 2010.

Graco has additional information available in a PowerPoint slide presentation, which is available as part of the webcast player. At the request of the Company, we will open the conference up for questions and answers after the opening remarks from management, and instructions will be given at that time. At the request of the Company, we will open up the conference for questions and answers after opening remarks from management and instructions will be given at that time.

During this call, various remarks may be made by management about their expectations, plans and prospects for the future. These remarks constitute forward-looking statements for the purposes of the Safe Harbor provisions of the Private Securities Litigation Reform Act. Actual results may differ materially from those indicated as a result of various risk factors, including those identified in Item 1A of, and Exhibit 99 to, the Company's 2009 Annual Report on Form 10-K. This report is available on the Company's website at www.graco.com and the SEC's website at www.sec.gov. Forward-looking statements reflect management's current views and speak only as of the time they are made. The Company undertakes no obligation to update these statements in light of new information or future events.

(Operator Instructions)

I will now turn the conference over to Caroline Chambers, Vice President and Controller.

Caroline Chambers - *Graco - VP and Controller*

Good morning and welcome to everyone. It is a pleasure for Pat McHale, Jim Graner and me to be with you this morning.

Today I will provide some comments on the financial highlights of our first quarter, and Pat will follow with additional comments. As noted earlier, PowerPoint slides are also available to accompany the call, and can be accessed on our website. After our opening comments, we will open up the call for your questions.

For our first quarter, net sales were up 19% to $165 million. Sales increased in all divisions and regions, with significant growth in Asia Pacific and moderate growth in Europe. We are pleased to report that operating earnings as a percentage of sales increased to 20%, up from 4% a year ago, with net earnings totaling $21 million. Currency translation had a favorable effect on sales of $5 million, and on met earnings of $2 million.

Our gross profit margin as a percentage of sales was 54%, as compared to 47% for the first quarter last year. This improvement was primary due to currency translation, workforce reduction costs in the last year, and higher production volumes. Lower material and pension costs, price increases and product mix also contributed to the higher margin rates. Operating expenses were down 3% as compared to last year, as we saw the benefits from cost reduction activities in prior years, and lower pension expense. These improvements were partially offset by the effect of currency translation, and increases in bad debt expense. As we expected, volume-related items such as incentive accruals are readjusting.

The tax rate was 34.5% this quarter. The Federal R&D tax credit has not been renewed for 2010, and no benefit is included in the current rate. Our first quarter cash flow from operations was $16 million. Our primary uses of cash were capital expenditures of $3 million, dividends of $12 million, and long-term debt repayments of $6 million. Our working capital investment increased in line with our increasing volumes. To meet higher demand, inventories increased by $8 million, with an improvement in turns, and accounts receivable increased by $18 million with the higher sales level. Our days of sales outstanding remain consistent with prior periods.

On the financing side, our credit lines totaled $270 million, with $178 million unused at the end of the quarter.

With that, I'll turn it over to Pat for additional comments.

Pat McHale - *Graco - President and CEO*

Good morning.

In the first quarter we had double-digit revenue growth compared to both Q1 2009 and, more importantly, compared to Q4. We saw growth in most geographies and business segments, indicating a broad-based recovery is likely underway. Historically, Q1 has been our lost revenue quarter, so that increase is particularly encouraging.

The following comments compare Q1 2010 to Q1 2009. We had double-digit growth in Europe before currency benefit, with Eastern Europe and the Middle East growing at strong double-digit rates, and Western Europe growing at mid-single digits. Growth was fairly well-balanced across all of our product segments. Asia Pacific had a very strong quarter. China, Korea and Southeast Asia had the highest growth rates, but we also saw double-digit rates in India, Australia, New Zealand and Japan as well. We benefited from strong car, bus, truck, motorcycle and Tier One production in the region, as well as rail, energy production, mining, aerospace and construction. For Asia this quarter, it was approximately 10% higher than our peak Q1 pre-recession.

We also saw growth in the Americas. In North America, we saw nice double-digit growth in our industrial business, while contractor and lube were essentially flat to last year. In contractor North America, the pro paint business was down mid-single digits, offset by the home center business, which was up low double digits. The pro paint revenue comps were impacted by a Q1 2009 channel sale of approximately $1.5 million for an entry level product roll-out. The improvement in the home center business was primarily due to increased store count, and the roll-out of a new sprayer model to 1,700 stores of a major retailer in Q1 of this year. Contractors started the year off slowly, but had a strong March, and prospects should improve as we enter the painting season. Compared to Q4, both pro paint and home center improved significantly. Channel inventory appears to be stable, with no evidence of restocking yet.

In Latin America, off a small base, we had a strong quarter, with sales up double digits in every reporting segment.

Switching gears a bit, overall we were pleased with our operating performance, and gross margins were solid at 54% and up from Q4. Operating margins continue to improve with volume. There is a margin reconciliation for you in the slides that accompany the call. Industrial had a nice quarter, with 31% operating margins on revenue that remains well below pre-recession levels. Lubrication margins are trending in the right direction. Improvements implemented in the acquired businesses, along with volume increases and a reduction in one-time costs, are all contributing. We continue to invest in growth initiatives in lubrication, and a return to historical operating margin will require significant volume increases.

Contractor operating margins remain stable from Q4 at 10%, and remain well we low historical levels, due to volume declines that began in 2007 as the housing market crashed. Mix issues also continue to impact the profitability of this segment, as we continue to see lower demand on larger, higher-margin equipment. We continued to invest in our key growth strategies during the quarter, developing new products, recruiting and training international sales people, and selectively increasing distribution coverage. Although product spending -- product development spending was down compared to the first quarter of 2009, our spending was up from Q4 due to project timing. We continue to anticipate spending for the full year 2010 will be in the $40 million range.

Our new product sales as a percentage of the total increased to 27% in Q1, versus 26% for the full year in 2009. Our goal, as we have stated, is 30%. While products released in Q1 contributed to our sales results, we expect the impact to be greater as the year progresses. We have many products launching in Q2 and Q3. Our balance sheet is strong, and we continue to look for good acquisition opportunities. The M&A market has been challenging for the past 18 months. We expect the environment to improve as the economy recovers. Priorities for cash continue to be funding organic growth opportunities, making strategic acquisitions, and returning cash to shareholders through dividends and share repurchases.

In terms of outlook, we believe the global economy has entered recovery mode. While we don't expect Asia will continue with the period-over-period growth rates we saw in Q1, because of tougher comparisons for the rest of the year, we are positive on the near-term outlook for the region and expect solid performance from Asia in 2010. We also anticipate continued solid performance from Europe as the year progresses. The continued slow recovery in the US housing market, and the difficult conditions in the commercial construction market, will create near-term challenges for our Contractor division, and we will need good success with the new products to make significant headway in our key North American market this year.

This conclues my prepared remarks. I'll now ask the Operator to open the session to Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Our first question is from Kevin Maczka. Please state your question.

Kevin Maczka - *BB&T Capital Markets - Analyst*

Hi, good morning.

Pat McHale - *Graco - President and CEO*

Morning.

Kevin Maczka - *BB&T Capital Markets - Analyst*

Pat, congratulations on the quarter. I guess my first question, you mentioned in terms of seasonality, Q1 historically being the lowest revenue quarter; do you think we are back to the point in the recovery where we can talk about normal seasonality, with Q2 maybe being the best quarter, and Q3 and Q4 somewhere in between Q1 and Q4?

Pat McHale - *Graco - President and CEO*

You know, it is hard to say, because we are so early into what I see being the recovery here, but I think there are some signs that the recovery is broad-based. We are going to see the residential housing market in the US I think improve as the year progresses. I don't think the same can be said for commercial. So I'm not 100% confident in it, but I think that it is probably more likely than not.

Kevin Maczka - *BB&T Capital Markets - Analyst*

All right. And then I wanted to ask a question on the operating expense. Down 3%, you know, given the big revenue increase. You are adding sales people in international markets, you are doing a lot of product development work, you are rolling out new products all over the world. Can you give a little more color on how exactly you are finding the cost savings to offset all of those additional costs?

Jim Graner - *Graco - CFO and Treasurer*

Kevin, this is Jim. You know, last year, we did have about $1 million in operating expenses from severance costs, which did not repeat this year. Most of the expected headcount that you reference is going to happen in the second, third and fourth quarters; we have roughly 30 people in our international regions that are going to be added, so that you should project the trends for operating expenses to get higher as the year progresses.

Kevin Maczka - *BB&T Capital Markets - Analyst*

Okay. I think you said before that your expectation all-in was relatively flat operating expense, but maybe there would be some additional incentives and things like that, that would come back; is that still kind of directionally correct?

Jim Graner - *Graco - CFO and Treasurer*

Yes, you know, we indicated that if we met our plan, our planned incentive targets, you should see an incremental expense hit of around US$10 million for the year.

Kevin Maczka - *BB&T Capital Markets - Analyst*

And does that go up significantly with what presumably is better revenues than you would have expected?

Jim Graner - *Graco - CFO and Treasurer*

That's correct. You know, so we have provided in the first quarter, incentives relative to the level of sales we recorded, and that $10 million number will require an additional increase in revenues for the rest of the year.

Kevin Maczka - *BB&T Capital Markets - Analyst*

Okay. Then just finally, just a broad question on this contractor recovery. I would just like to get some more thoughts on how you see that playing out. There is a lot of product already in the field that was sold back at the prior peaks of the housing market. Do you see demand for your new products, or your existing products, coming back strong as those markets recover? Or will there be still a long lag there because of all the product that's already in the field?

Pat McHale - *Graco - President and CEO*

You know that product in the field is starting to get a little bit old. We're really talking about that peak being 2005, 2006, and so we are four or five years out from that. That business, of course, has been under kind of a double-digit decline here in North America for the last several years. So I believe it is likely that a lot of the used equipment has been burned up out there, as contractors have needed equipment over the course of the last three or four years, and just have taken one out of the back room or purchased one somewhere. It is hard to say what exactly is left, but certainly the passage of all this time from the last peak I think is in our favor.

The other thing that I think will help us once the recovery here in North America from a construction market is -- starts to be sustainable is that channel inventory will probably increase. Our channel partners did a nice job during the downturn of managing their inventories down, and their inventories are probably appropriate for the current market conditions, but we need to go up as demand improves.

So again, we think housing will get a little better. We think commercial is still going to be tough for the rest of the year. But at some point when that changes, we should get some benefit from inventory, and I think that our sales will follow. There may be some negative impact from the equipment out in the field, but that's got to be lessening.

Kevin Maczka - *BB&T Capital Markets - Analyst*

Okay. Thank you.

Operator

Thank you. And our next question comes from the line of Mike Halloran with Robert W. Baird. Please state your question.

Mike Halloran - *Robert W. Baird & Company, Inc. - Analyst*

Good morning. Is there any reason the first quarter margin here isn't sustainable on a go-forward basis, taking into account seasonality, obviously? And how much of a threat do you think the inflationary environment on the raw materials side will be?

Jim Graner - *Graco - CFO and Treasurer*

We were comfortable with our gross margin. You know, at the level of sales, you know, we are benefiting from more production through our factories. Last year, you know, we had roughly $25 million in manufacturing burden costs that didn't flow through inventory, that were period costs. We have reduced the run rate of that approximately 50% in the first quarter. So again, our prices have held.

Surprisingly, the first quarter as well, our material costs are favorable to our margin. You know, we are monitoring daily, weekly, the metal inflation, the inflation in the metal costs. So right now, Mike, we don't see any of that being a headwind that our pricing and our efficiency won't more than offset.

Mike Halloran - *Robert W. Baird & Company, Inc. - Analyst*

And so then, you know, the first quarter number seems like an operating margin that we can build off of, and I think you said there was really no push back on the pricing side. So I think in the past you had said about 150 to 200 basis points in pricing in 2010; does that still hold?

Jim Graner - *Graco - CFO and Treasurer*

Yes, that is still correct.

Mike Halloran - *Robert W. Baird & Company, Inc. - Analyst*

Okay. Appreciate the time.

Operator

Thank you. Our next question comes from the line of Charles Brady with BMO Capital Markets. Please go ahead.

Tom Brinkmann - *BMO Capital Markets - Analyst*

Good morning. This is actually Tom Brinkmann standing in for Charlie Brady. Just a follow-up on some of your earlier comments. I'm curious, with all the new products you have rolling out, maybe you could talk about by 2011 what kind of percentage you see of new products, you know, sales, versus your overall sales?

Pat McHale - *Graco - President and CEO*

You know, our goal is to get to the 30% number. But keep in mind that that's not all incremental. We spend a fair amount in product development to make sure that our base product offering is cutting-edge technology, and that we can continue to maintain our leadership position out in the field. So you know, you can't take increases or decreases in that number and necessarily roll them right into the P&L. We have definitely over the course of the last 18 months focused more in the divisions on developing products that are purely incremental, through some of the new market initiatives that we've got going on.

So I do believe that if you look forward into the back half of 2010, into 2011, that we are likely to have more incremental growth on new products. But you know, most of the time, our new products are not $100 million kind of deals. They are not game changers. There is a lot of them and they move the needle in aggregate, but not individually.

Tom Brinkmann - *BMO Capital Markets - Analyst*

Right. Can you just talk about how -- I guess how the gross margins would differ from the new products and the existing legacy products?

Pat McHale - *Graco - President and CEO*

It depends on which part of the product line we are looking at. Historically, I guess with the exception really of our -- I'll call it our entry level or home center kind of products, the new products are equivalent to or maybe slightly better than existing products in terms of margins. To the extent that new product is slanted towards entry level or home center, those margins are less.

Tom Brinkmann - *BMO Capital Markets - Analyst*

Okay. And I guess you talked about not having any evidence yet of restocking, I believe you said, in both the home center and pro paint channels. What is your visibility now into I guess North American stores? What are the trends there in terms of demand? How do you see that progressing over the course of the year?

Pat McHale - *Graco - President and CEO*

Are you talking specifically in terms of Contractor?

Tom Brinkmann - *BMO Capital Markets - Analyst*

Yes.

Pat McHale - *Graco - President and CEO*

Well you know I believe that second quarter is going to be better because we are entering the painting season, and it historically is, and I think the order trends that we saw in March indicate that that is going to be the case. I'm not seeing a high desire by the channel partners to bet on the come, and load up their stores with inventory yet. I think we are going to need to see it before we would see any significant kind of inventory restocking. To be honest with you, I would be surprised if that happens this year. I would be more optimistic for some significant inventory restocking in 2011.

Tom Brinkmann - *BMO Capital Markets - Analyst*

Okay. And you mentioned orders; can you comment at all on the orders basically by segment overall? Not just by geography, but also across the whole Company?

Pat McHale - *Graco - President and CEO*

Talking about our incoming order rate?

Tom Brinkmann - *BMO Capital Markets - Analyst*

Yes.

Pat McHale - *Graco - President and CEO*

In aggregate, our incoming order rate for the beginning here of April looks to be fairly consistent with what's been happening through the first quarter. So we don't see any cracks happening at this point, but of course it's early. We have been strong, really, across the geographies and across the product segments.

Tom Brinkmann - *BMO Capital Markets - Analyst*

Okay. And then, speaking of geographies, Asia was particularly strong this quarter. Just wondering, how much of that is, you know, new market penetration as you sort of build out your capabilities there? How much are you taking share? How much of that is just a reflection of the overall market growth?

Pat McHale - *Graco - President and CEO*

Well, I think a big piece of it is what's happened with the economy over there. The economy is strong in most of those regions. But you will recall that during the downturn here in 2008 and 2009, we continued to invest. So more people, more distributors, so it is a combination, I'm sure. Certainly I'll take a great economy over anything else. But when you have a strong economy and you have made the investments, hopefully you can capitalize off those.

We don't have any way to measure in any kind of a pure way what is happening with market share. We can tell you where we are putting people and where we are putting distribution, and the growth is good and the economy is strong, and all in all it seems to be working.

Tom Brinkmann - *BMO Capital Markets - Analyst*

Okay, that is all I had. Thank you.

Operator

Thank you. And our next question comes from the line of John Franzreb with Sidoti & Company. Please go ahead.

John Franzreb - *Sidoti & Company - Analyst*

Good morning, guys.

Pat McHale - *Graco - President and CEO*

Good morning, John.

John Franzreb - *Sidoti & Company - Analyst*

Pat, could you just talk a little bit about your [jobber] customer base? In the past, you mentioned they were kind of reluctant to restock. Do you think the inventory levels are now at equilibrium, or what's your sense of their current spending patterns, are they still conservative?

Pat McHale - *Graco - President and CEO*

When you talk about jobber, what segment are you referring to?

John Franzreb - *Sidoti & Company - Analyst*

Industrial.

Pat McHale - *Graco - President and CEO*

Okay. On the industrial side, there may be a few little areas where there is some restocking going on, just to support the fact that demand is better. But in general, we don't have any evidence that that has changed dramatically, and to be honest with you, in most of our industrial businesses, the distributors, other than spare parts, don't stock a ton of completed units, because our industrial product is very high-mix, low-volume kind of stuff, and configurable, and so distributors order it when they are working on a project.

So I believe that most of the performance that we are seeing out of our industrial division is directly related to end demand, with the exception of maybe some spare parts in certain geographies, where we are getting a little bit of benefit.

John Franzreb - *Sidoti & Company - Analyst*

Okay. And could give us a little color about the lubrication side? You had a nice uptick sequentially as far as the revenue side. Can you talk about your thoughts about how you expect the progression of the recovery to unfold a little bit over the next year?

Pat McHale - *Graco - President and CEO*

Well, you know, the declines were similar to our industrial business, and it wouldn't surprise me to see it come back sort of in similar fashion. One big exception there is the fact that we are pretty heavily weighted towards the vehicle services North America.

John Franzreb - *Sidoti & Company - Analyst*

Okay.

Pat McHale - *Graco - President and CEO*

Not seeing any signs that dealers are going crazy yet in terms of making investments, although I think with the uptick in car sales, and just the general improvement in the economy here, we will see some strength in that as the recovery picks up. But you know, with that exception, the industrial lube initiative and what we are doing internationally, I would think could move along in line sort of with our industrial recovery.

John Franzreb - *Sidoti & Company - Analyst*

Okay, great. Thanks a lot.

Operator

Thank you. Our next question comes from the line of Ned Borland with Hudson Securities. Please go ahead.

Ned Borland - *Hudson Securities - Analyst*

Hi guys. Great quarter. I just have one question, going back to seasonality. You touched on it in Contractors, it seems like there was -- in normal years, not so much last year, but before that there was sort of a seasonal uptick in industrial, and I was just wondering, you know, given some restocking activity, would you expect a similar seasonal, you know, move upwards sequentially in the second quarter? Or would it be, you know, maybe a little bit more muted?

Pat McHale - *Graco - President and CEO*

For our consolidated global performance, I would expect that if the recovery doesn't weaken on us here, that we would see hopefully a more normal pattern going into the second quarter, with some uptick.

Ned Borland - *Hudson Securities - Analyst*

Okay, and then again back to cost headwinds in that segment. I mean, other than raw materials, and perhaps some product development spending, are there other costs that we should be thinking about in that segment?

Pat McHale - *Graco - President and CEO*

You'll have to make your own call on what currency is going to do.

Ned Borland - *Hudson Securities - Analyst*

Okay. All right. Thanks.

Operator

Thank you. Our next question is from the line of Christopher Glynn with Oppenheimer & Co. Please go ahead.

Christopher Glynn - *Oppenheimer & Co. - Analyst*

Good morning. A question on Contractor. If we are operating from a baseline of normal seasonality, I think you heard you had some retail channel fill in the first quarter; would that act against a normal seasonal pattern?

Pat McHale - *Graco - President and CEO*

A little bit.

Christopher Glynn - *Oppenheimer & Co. - Analyst*

Okay. Just a little, then. From the fourth quarter to the first, you had it looks like a little bit of an abnormal uptick from normal seasonality as well, but we didn't see the margin move sequentially. Was that mix related to the channel fill or --

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Jim Graner - *Graco - CFO and Treasurer*

It's partially mix and it's partially that our operating expenses generally are weighted more to the first three quarters of the year versus the fourth quarter.

Christopher Glynn - *Oppenheimer & Co. - Analyst*

Okay. Thanks. That's all I had.

Operator

Thank you.

(Operator instructions)

Our next question is from the line of Matt Summerville with KeyBanc. Please go ahead.

Matt Summerville - *KeyBanc Capital Markets - Analyst*

A couple of questions. I wanted to follow-up on Asia a little bit, Pat. Do you know how much the year-over-year growth, I think organically it was 55% in the quarter, how much of that would you say was relegated to China? And are you seeing any signs over there in your business that some of the efforts that are at least being talked about with regards to the government are starting to slow things down over there at all?

Pat McHale - *Graco - President and CEO*

You know, it is interesting. First of all, back to where the growth come from. We had a big quarter in China. We also had a big quarter in Southeast Asia and in Korea, and we saw again double-digit growth in India, Australia, New Zealand and Japan. So it is not just China, the whole region seems to be running rather well right now.

You know, from -- the Chinese government's efforts to slow the thing down, we have been hearing that now year over year for quite some period of time, and they seem to be fairly unsuccessful in being able to do that. Again, I wouldn't be building into any kind of a model a 55% growth rate for the rest of the year, over the tougher comparisons. But the team over there is pretty confident that if there is a bubble building in China, it's probably not going to burst this year. They see pretty strong demand in the automotive segments lasting at least another two or three years. And so, you know, we are more optimistic, I think, that we are not going to see the thing clamp down too much here this year.

Matt Summerville - *KeyBanc Capital Markets - Analyst*

Sticking with Asia, and this is kind of a follow-up to someone else's question, Pat, do you know -- the magnitude of growth you saw again was pretty phenomenal; how much of that do you think is kind of Graco making its own luck with the strategic investments that you kept on making through this downturn, versus the overall improvement in kind of the macroenvironment? And at the same time, do you feel that there is any more inventory being built among your customer base there than what you're seeing in other parts of your businesses?

Pat McHale - *Graco - President and CEO*

Perhaps if you are in year 2009, I would love to say that the quarter in Asia was because we are all geniuses and everything we did worked perfectly, but I don't think in reality that is probably the case. I think the reality is it is a combination of a very strong economic situation, and hopefully the fact that we have continued to invest and grow our channel is having a payback. There is really no way for us to sort that out, over the short term. Over a longer period of time, we can get some baseline metrics on our initiatives, but quarter to quarter, that is not really possible to do.

Matt Summerville - *KeyBanc Capital Markets - Analyst*

You had mentioned in Contractor, I believe domestically, that the home center channel was up in the low teens range, I think, part of that being related to a new product rollout to 1,700 stores on the part of one of your customers. If you kind of exclude that, how would the underlying order tempo look in the home center channel versus the professional paint side?

Pat McHale - *Graco - President and CEO*

I don't know. I haven't done that calculation. Sorry.

Matt Summerville - *KeyBanc Capital Markets - Analyst*

Okay. Thanks, Pat.

Operator

Thank you.

(Operator instructions)

If there are no further questions, I will now turn the conference over to Pat McHale, President and Chief Executive Officer.

Pat McHale - *Graco - President and CEO*

All right. I'll give my normal long speech at the end of the call. Thanks for joining us this morning, and have a good day.

Operator

This concludes our conference for today. Thank you all for participating, and have a nice day. All parties may now disconnect.
