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GGG - Q4 2013 Graco Earnings Conference Call

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OVERVIEW:

GGG reported 4Q13 sales of $272m and net earnings of $45m or $0.71 per diluted share.

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PRESENTATION

Operator

Good morning, and welcome to the fourth-quarter and year-end 2013 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 3035903030.

The conference ID number is 4659630. The replay will be available through January 31, 2014.

Graco has additional information available in a PowerPoint slide presentation which is available as part of the webcast player. As a request of the Company we will open the conference up for questions and answers after the opening remarks from management.

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 the Company's 2012 annual report on Form 10-K and in item 1A of the Company's most recent quarterly report on form 10-Q. These reports are available on the Company's website atwww.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 the light of new information or future events.

I'll now turn the conference over to Caroline Chambers, the Vice president, Corporate Controller, and Information Systems. Please go ahead.

Caroline Chambers - *Graco Inc. - VP, Controller & Information Systems*

Good morning everyone. I'm here this morning with Pat McHale, Jim Graner and Christian Rothe. I'll provide some top-level discussion on our overall financial results for our fourth quarter and then we'll turn the call over to Pat.

Slides are available to accompany our call and can be accessed on our website. The slides include information about our consolidated financial results for the quarter in our usual format.

Sales this quarter totaled $272 million, an increase of 7% from the prior year. We saw sales growth of 10% in industrial segments and 5% in the contractor segments; the lubrication segment sales declined by 3% for the quarter.

Regionally, sales in the Americas grew by 4%, sales and EMEA increased by 8%, or 4% at consistent translation rate. Growth in the Asia Pacific was 14% or 16% at consistent translation rate with increased sales in the region related to completion of powder finishing projects and other industrial activity. Pat will give more detail by region and segments in a moment.

Net changes in currency translation rates from the prior year did not have a significant effect on sales or operating results for the quarter overall. Favorable currency translation from the Euro offset unfavorable currency translation change from Asian currencies.

A table showing impact of volume acquisitions in currency by segment and region is included on page 5 of the slides. Net earnings totaled $45 million, or $0.71 per diluted share for the quarter. Page 8 of the slide deck provides a quarter-over-quarter overview of change in operating earnings.

Gross profit margin as a percent of sales was 54% for the quarter, a decrease of a 0.5 percentage point from the prior year. Manufacturing spending and changes in product mix, including the effective increased sales of powder finishing systems during the fourth quarter offset the effect of realized pricing.

Manufacturing spending during the fourth quarter included increased levels of expenditures related to implementation of new factory equipment as compared to earlier quarters of 2013. We expect usual factory spending levels going forward.

Operating earnings improved by a 0.5 percentage point from the prior year during the fourth quarter though contractor segment expenses increased by $3 million as compared to the prior year due to an increase in product developments and prelaunch activities for new products expected to be released in the first quarter of 2014. Acquisition and divestiture costs were insignificant in the quarter as compared to $1 million for the fourth quarter last year.

Fourth quarter unallocated corporate expenses included $3 million additional expense for share-based compensation as compared to the prior year. This item has been included in the reconciliation of operating earnings found on page 8 of our slides.

The expenses related to increased value with cash stock appreciation rights plan for international employees and a new branch of options for North American-based employees. A program to grant options to non-executive, non-manager employees has historically been put in place on a three-year cycle.

Other income includes dividends from the liquids finishing business of $4 million for the quarter and in $28 million year-to-date. Once again, a brief discussion on the background of this investment and the dividend.

The liquid finishing businesses were purchased in April 2012. It is reflected as a cost investment on our balance sheet and the financial results are not consolidated.

Under terms of the Hold Separate Order from the Federal Trade Commission, we cannot exercise direction or control of the operations of liquid finishing nor can we exert significant influence over the liquid finishing operation. Income is recognized based on dividends received from after-tax earnings and is included in other income and Graco's income statement.

$4 million of dividends were received in the fourth quarter. A higher level of dividends were distributed in the second and third quarters of 2013 to reduce cash and undistributed earnings in the Hold Separate Operations.

We have not yet received a Final Order from the FTC requiring a divestiture of liquid finishing. Of course, when the Final Order is received and the sale of this investment is completed, there will be no further dividends or income stream from the liquid finishing investment.

The effective tax rate for the quarter of 28.5% is comparable to the 28% tax rate in 2012. The fourth-quarter 2012 tax rate was favorably affected by a tax holiday received in a foreign jurisdiction.

The lower full-year 2013 tax rate of 27% as compared to the 31.5% rate in 2012 reflects the higher level of dividends received from the liquid finishings businesses and the federal R&D tax credit that was renewed in 2013 effectual retroactive to the beginning of 2012. There was no R&D tax credit recognized in 2012.

We have included our usual slides about segment results in the slide deck starting on page 12. Net cash provided by operating activities was $62 million for the quarter with changes in working capital and in line with business volumes and consistent with prior quarterly trends.

Inventory balances support upcoming contractor's Spring demand and growth in powder finishing products. Capital expenditures were $8 million and we paid dividends of $15 million in the quarter. We also continued share repurchases in the fourth quarter with approximately $40 million of repurchases.

Our outstanding long-term debt was $408 million at the year end with net repayments of $148 million made during 2013. The liability for pension and other retirement benefits decreased by approximately $40 million as compared to the prior year. A $9 million voluntary contribution was made to the US funded pension plan during the fourth quarter.

The investment policies for the US funded pension plan are based on a long-term view of economic growth and are heavily weighted toward equity securities and the plan benefited from favorable asset performance. The US and other plans also benefited by the increase in discount rates as compared to the prior year.

The annualized tax rate is expected to be approximately 29% to 30% in 2014. This assumes receipt of $28 million in post-tax dividends from the liquid finishing investment, an amount equivalent to 2013.

The federal R&D tax rate has not been extended into 2014. If approved, the annualized tax rate is expected to drop about 1 percentage point to approximately 28% to 29%.

The EcoQuip and QED Environmental Systems businesses were acquired with combined revenues of approximately $30 million. Both operations are part of the industrial segment. Both acquisitions were completed in December 2013 though the QED acquisition closed subsequent to year-end.

Going forward, we expect unallocated corporate expenses to be in the range of $5 million to $6 million per quarter taking into account an expected higher run rate for share-based compensation and a lower expense related to pension. Capital expenditures for 2014 are expected to be in the range of $25 million to $30 million.

This includes $5 million to $8 million for the fit-out and equipment of a new lease distribution center in the Twin Cities area. A space will be available by midyear with move cost expected to be $1 million to $2 million during the second half of the year, an annual operating cost of $3 million.

Dividends from the liquid finishing hold separate operations are currently planned to be $28 million for 2014 with a similar quarterly distribution as compared to 2013. However, the issuance of the Final Order from the FTC and the results of the sales process, the Hold Separate Operations will affect the actual amount and timing of the dividend distribution.

We anticipate that the total future cost of a divestiture will be approximately $10 million though the timing of expense and final amount will be affected by the sale and regulatory review process in duration. We have continued with share repurchases in January. With that I'll turn the call for to Pat for more comments on the quarter.

Pat McHale - *Graco Inc. - President & CEO*

Thanks, Caroline. Good morning, everyone.

This morning I'll provide some commentary on the trends we saw in our business in the fourth quarter and our outlook into 2014. Topline growth in Q4 was decent at 7%, although we continue to see variation from region to region and segment to segment. We'll get into the details of the performance by business in a moment but here are a few high-level comments.

Our industrial segment outperformed our own expectations in the fourth quarter. The outperformance was driven by China and was largely due to project activity within a couple of specific product categories.

For the quarter, billings were stronger than bookings in Asia-Pacific industrial. For industrial in the Americas and in EMEA Q4 bookings outpaced billings.

The contractor segment in North America grew 9% year-over-year. Out-the-door data for our channel partners indicates that end-user demand growth remained in the double digits.

We have a large number of new products launching in 2014 and believe year-end orders were somewhat muted because some retailers were conservative replacing year-end stocking orders of existing product in anticipation of the new lineup that will be available in 2014.

While the Company's topline was near expectations the overall earnings were somewhat below expectations. There were two discrete items that impacted earnings in the fourth quarter.

The first related to increased expense in are contractor segment for marketing a new product development and preparation for products that are launching in the first half of 2014. We disclosed the potential for these additional costs on the conference call last quarter. At that time we believed the expense increase would be in the $1 million to $2 million range; actuals came in higher than $3 million.

The other discrete item that impacted earnings by about $3 million in the fourth quarter was our decision to grant stock options to our rank-and-file employees. While not guaranteed, approximately every three years or so we've done a similar grant in order to align all Graco employees with shareholder interests.

From an incremental profit perspective I'm satisfied with the overall performance for the quarter and the year. The industrial segment flow-through profitability was around 50%, a strong performance. While Q4 contractor operating earnings declined year-over-year due to the discrete spending increase, flow-through profitability for contractor for the full year was in excess of 40% and we are well-positioned heading into 2014.

Now we'll walk through to the regions and segments. My comments are based on year-over-year performance for the quarter and a full year on a constant currency basis and exclude the impact of acquisitions.

First, Asia-Pacific. Overall, Asia-Pacific was up 16% compared to the fourth quarter of 2012, but performance was variable throughout the region and within the segments.

Both lubrication and contractor segment sales were down double digits. Mining remains an overhang in China, Southeast Asia and Australia, and was a drag on lubrication in the quarter.

The industrial segment in Asia-Pacific grew 28% in the fourth quarter, easily the strongest organic growth performance of the year and drove the region to growth for the quarter and the year. We shipped a number of projects out of our backlog in the fourth quarter including powder systems for various end-markets, and advanced fluid dispense equipment destined for automotive and construction end markets.

We're also seeing good growth from our high-performance coatings and foam equipment and construction markets in China. We continue to see weakness in a number of other industrial end markets throughout Asia including shipyards, container manufacturing, infrastructure, heavy machinery and general manufacturing. For the full year the Asia-Pacific region posted organic growth of 1%.

Moving on to EMEA. Every segment of EMEA grew in 2013. Good performance by the team in a week macro environment.

We grew 4% in EMEA in Q4 similar to the third quarter. Geographically, the Western European economies continue to be spotty from quarter to quarter and we posted low single-digit growth in Q4.

The emerging economies of EMEA grew at a double-digit pace in the quarter and demand was broad-based. We ended the year with 64% of our sales from the Western European economies.

Our industrial segment in EMEA saw good demand for protective coatings, liquid finishing and foam and polyurea equipment resulting in 4% growth in the quarter. Contractor sales also grew 4%.

While the housing market remains weak, our team continues to successfully drive our divisional growth strategies. The lubrication business in EMEA was down slightly in the fourth quarter but posted double-digit growth for the year.

Moving to the Americas. All segments posted growth in the Americas in the fourth quarter led by the 9% growth in are contractor segment. Out-the-door sales were up double digits for both the home center and paint store channels in the fourth quarter.

Our industrial segment in the Americas grew 4% in the fourth quarter driven by sales of powder and process applications as well as growth from our hot melt packaging initiative. The lubrication segment in the Americas posted slight growth for the quarter and the year reflecting modest demand growth in vehicle service application and a slow pace of investment by industrial lubrication customers.

Before moving on to our outlook for the first quarter and the full year 2014, I'd like to discuss two topics that I anticipate will come up in the Q&A -- the new products that will be coming online for our contractor segment and some of our organic growth initiatives for 2014. In contractor we're upgrading our full line of airless professional paint sprayers.

The team has worked a number of new features and benefits into the product line making them easier to use, faster and easier to maintain. We will begin shipping in the first quarter or early in the second quarter.

In 2014 we're also making incremental organic growth investments in other areas. A year ago I promoted two strong longtime leaders of the organization into newly created Vice President positions within the Company, creating a process division in the South and Central America region. And I'm pleased with the progress of these teams in their first 12 months and they have identified a number of new growth opportunities that we will incrementally fund.

In process, the engineering team has been working on several interesting new product concepts. I really like the ideas and we're planning to increase the engineering investment in order to commercialize these sooner.

We're also selectively adding some commercial resources to this group to get more feet on the street. The process group is also actively seeking acquisitions that complement their technological expertise, which is how we came to add QED, an acquisition that closed just after the end of our 2013 fiscal year. While small, QED builds off our manufacturing and engineering knowledge of air operated pumps and exposes us to the growing environmental remediation market.

In our new South and Central America region we've already added a number of sales and marketing resources and will continue to grow the headcount in 2014. This region offers new revenue opportunities for us but it's a big geography and we need more sales and distribution in order to capitalize.

In all, these businesses are looking to grow their headcount by couple of dozen people by the end of the year. We're also making investments in personnel worldwide to grow our presence in the hot melt packaging space that we targeted in 2013 with some early success.

As most of our long-term investors know, Graco is an ROI culture and we make investment decisions for the long term. Although organic initiatives take time to germinate, we believe we've got some good new ideas, expenses will be higher in 2014 but I'm confident there will be a long-term return.

Now for our outlook. The outlook for 2014 is unchanged from our initial guidance at the end of the third quarter of 2013.

We expect to show a full-year growth in each of our regions and in each of our reportable segments. We anticipate results will continue to be uneven quarter to quarter and between geographies and product lines but believe Graco can pull us mid-single-digit growth for 2014.

In the Americas the contractor segment should grow double-digit for the full year but the rate of growth will decelerate from 2013 as we're up against tougher comps. Our outlook is based upon US housing starts in the range of $1.1 to $1.2 million.

The industrial business in the Americas should grow in the mid-single-digit range this year, and for our lubrication business in the Americas we expect low- to mid-single-digit growth. Overall, for the Americas growth should be in the mid to high single digits for the year.

We also expect growth in EMEA at a mid-single-digit pace. In Asia-Pacific due to a new low backlog entering the year we're expecting sales in the first quarter to be down high single digits to low double digits. First quarter of 2013 in industrial Asia-Pacific was our biggest quarter of the year and our current run rate on bookings in the fourth quarter would indicate this level of decline.

It will take a little while to dig ourselves out of the hole from the first quarter. But we do expect that we will end the year with low single-digit growth in Asia-Pacific in 2014.

Our factories continue to perform well and we believe that the price cost equation will be neutral to favorable in 2014. A few comments on the liquid finishing divestiture process. As has been the case for nearly two years now we continue to dialogue with the FTC on the remaining items that are outstanding to bring the final Decision and Order to completion and begin the sale process.

Progress has been made in the months since our last conference call but we aren't in a position to speculate as to when we can expect this chapter to be closed. In the meantime the liquid finishing business has performed well in 2013 with good top- and bottom-line growth. After certain adjustments to account for stand-alone costs that a potential acquirer may incur, we believe that the trailing 12-month EBITDA is now in the mid to high $50 million range.

We're often asked what we think we may be able to get for a multiple of EBITDA in this business. It's really tough to speculate as our situation is somewhat unique.

We are confident, however, that we will be in a position to recover our investment in the business and optimistic as to what we may be able to get. We will be focused but patient in redeploying the proceeds. In today's environment of elevated equity values and high deal multiples, discipline is paramount.

We're focused on making logical, prudent investments in our business, organic and inorganic, and generate the best overall returns. Our organic growth plans can be funded from our current operations so we continue to evaluate acquisitions and returns of value to shareholders as opportunities.

We expect to receive intercompany Hold Separate dividends in 2014 at a rate and in amounts that are identical to 2013. We're giving this guidance now so that those of you that model the dividends have a uniform level of guidance and to not distort consensus.

Of course, once the business is sold we will remove the excess cash pre-closing and hopefully also book a gain on the transaction. Both of these will hit our P&L on the other income line and the dividends will cease.

Overall, I'm excited for 2014 and look forward to achieving record performance again this year. This concludes my prepared remarks. Operator, we're ready for questions.

QUESTIONS AND ANSWERS

Operator

Thank you. (Operator Instructions). Kevin Maczka, BB&T.

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

First question on some of the costs in the quarter that were elevated. We had product development, we had some pre-launch costs in contractor, there was a comment about manufacturing spend and maybe that was elevated and goes back to more normal levels going forward.

Can we kind of break out here what you view as the, I don't know if one time's the right word, because things like product development and pre-launch is always happening, but what can we assume goes away from some of those elevated costs things? And I know there was a stock option item as well.

Jim Graner - *Graco Inc. - CFO*

So, I'll give it a go. In the fourth quarter we had about 0.5 percentage point in elevated costs in our manufacturing group. I don't want to call them one time because they're project related and projects will reoccur in the future but they were concentrated in the fourth quarter and that drop in margin probably should have been spread over the full year, or should be spread over the full-year in your model going forward.

With respect to margins in 2014, of course you heard Pat's comment on the favorable cost structure we're looking at and we are also expected to get about a 1.5 percentage point realized price increase. With respect to the $3 million in incremental spend in the contractor division both in product development and in marketing expenses, we think that will normalized to about a $1 million increase in the first quarter vis-a-vis the first quarter of 2013.

Again that's in the contractor segment in and of itself. And otherwise we'll expect normal inflationary kinds of increases plus the expenses that Pat laid out for our organic growth initiatives.

With respect to the costs on the stock compensation there's really two elements. We do periodically an all-employee grant. By all-employee, we're talking about non-executive, non-key manager stock compensation.

It comes in two forms. First is stock appreciation rights that we give to people outside, generally outside the US because of tax laws in those countries.

As you know we had some nice increases in our stock price in the fourth quarter of 2013. That added about $1 million to our run rate for the stock appreciation rights.

In addition we granted all employee stock through the US non-executive team and in the same amount of shares as previously done, and as you know the Black-Scholes formula gives you a higher value when your stock price is higher, so that basically doubled our expense for the stock option grants. Roughly about $4.5 million for the next three-year period during which those vest.

In our plan we have a structure that gives immediate vesting to the retiree-eligible employees, so under the accounting for stock options we take that as a one-time cost for those people that are retiree eligible. That represents the $2 million increase that's reflected in the quarter.

For the full year of 2014 that increase will be $1 million, about $1.2 million in expense. So again, it's the accounting impact for the fact that we have vesting based upon a retirement element. Hopefully, that helps?

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

Yes, Jim, that's pretty helpful. If I can bring it back to the contractor segment specifically, we had 4 points on the margin this quarter from the product development and the higher selling expense, so are you saying that not all of that goes away, if you will, but a good portion, maybe half of it does as we kind of go back to a $1 million run rate in Q1?

Jim Graner - *Graco Inc. - CFO*

Exactly. And we're, again, forecasting some higher revenue so that percentage of sales will be different.

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

Okay.

Jim Graner - *Graco Inc. - CFO*

Hopefully, a little bit lower.

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

Right. Okay, and maybe one more for me.

On Asia, that was much stronger this quarter. It drove the growth in industrial.

You were very clear about your guidance for Q1 for all of Asia-Pac and for the year. But in terms of your comments on Q4, in China and the strength there and being better than you expected, were there some discreet kind of one-time type shipments that happened there that drove that because that was really quite a turnaround in Asia-Pac growth?

Pat McHale - *Graco Inc. - President & CEO*

Yes, I wouldn't necessarily call them one time because a healthy portion of that business is project related as capital investments are made by our customers over there. But there was a concentration in the fourth quarter of some significant projects that went through, and we did ship backlog. So just trying to make sure that we're clear about what we see in terms of tempo there versus the billings and numbers that we reported.

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

Right. So we don't have that similar type of cadence for project shipments in Q1 and we also have a much difficult, more difficult comp, so that's why we see the down maybe double digits?

Pat McHale - *Graco Inc. - President & CEO*

That's correct.

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

Okay. I'll get back in queue. Thank you.

Operator

John Franzreb, Sidoti and Company.

John Franzreb - *Sidoti & Company - Analyst*

In your prepared remarks you put an outlook out there for 2014 that embeds a mid-single-digit growth profile for the lube business. That clearly hasn't been the case in the past year. What gives you the confidence that that business is going to rebound in 2014?

Pat McHale - *Graco Inc. - President & CEO*

The lube came off of a couple of strong years of growth and while flatter this year there was lots of activity both on the new product launch side and on working on some key customer accounts that give us some good reason to believe that we can have a better year in 2014.

John Franzreb - *Sidoti & Company - Analyst*

Nothing specific such as new product introductions or just --

Pat McHale - *Graco Inc. - President & CEO*

No, we launched, of course we launch new products every year, but we launched some good products in lube in the second half of 2013 including a new product that goes on large pieces of mining and construction equipment that we didn't have in our product line before to do automatic lubrication. Typically we call the product the Electric Dyna-Star.

We also launched a broad offering of powered hose reels that we did not have in our product line before. Again those products are all incremental.

In addition, they've done a lot of work with some key OEM accounts to capture new business. And we think the combination of those give us an opportunity to grow in 2014.

John Franzreb - *Sidoti & Company - Analyst*

Okay. Your last remarks surrounded liquid finishing in the divestiture. Could you bring us up to speed on what is taking so long, firstly?

And secondly, if I heard your comments properly, if this was to last another year we'd be looking at a dividend distribution of roughly $4 million in change, $9 million, $9 million to $4 million, is that what we should be doing for modeling purposes?

Jim Graner - *Graco Inc. - CFO*

I think to answer to your last question first exactly the model we'd like you to use. Again, equivalent to what we did by quarter in 2013.

With respect to the issues at the FTC it's really clarification of some intellectual property issues and which entity owns which patents. Again, these issues refer to about $1 million in revenue that separate business will continue but we just want to make sure that we have the right running rules and ownership of this IP going forward.

John Franzreb - *Sidoti & Company - Analyst*

Okay. It seems an awful lot of delay for $1 million of disputed revenue.

One last piece. The QED acquisition seems to be outside substantially outside maybe normal Graco targeted markets. Can you talk a little bit about the attraction of that purchase?

Pat McHale - *Graco Inc. - President & CEO*

Yes, this is Pat, I'll talk a little bit about that. We've split up our view of the world a couple of different ways when we look at M&A, and one is to take a look at actual pumping, metering, mixing, dispensing technologies.

So we look at the underlying technology and then we do another cut by end market. And while the environmental remediation is a new end market for us, pumping technologies that they use to do the groundwater sampling are very much in line with our existing core competencies in both engineering and manufacturing.

So we think it's a good fit. We like the business.

They've got a good management team. They play in an interesting end market that we don't participate in today. But our manufacturing and purchasing base should be able to be leveraged as well as we well understand the core technology.

John Franzreb - *Sidoti & Company - Analyst*

Are the returns similar to Graco-type returns, Pat?

Jim Graner - *Graco Inc. - CFO*

Their EBITDA is as typical of our, I'll call them fold-in acquisitions, is a little bit less than our current. We expect on the manufacturing side to be able to add significantly to their operating profits and hopefully we can add some to the top line as well.

John Franzreb - *Sidoti & Company - Analyst*

Thank you, Jim. Thanks for taking my questions.

Operator

Walter Liptak, Global Hunter.

Walter Liptak - *Global Hunter Securities, LLC - Analyst*

Wanted to ask about the outlook. You'd mentioned that the industrial business might be a bit choppy. I think we said.

And is that because of the Asia business? Is that what you're referring to by that or is there something else?

It sounds like Asia will be stronger and then it's going to weaken a little bit in the first quarter. Is that the choppiness that you're suggesting?

Pat McHale - *Graco Inc. - President & CEO*

No, really we've seen it for the last number of quarters. When you take a look at coming out of the recession in 2010, 2011 and most of 2012, our industrial business was more predictable where we saw pretty much regular growth across geographies and product lines.

And really throughout 2013 in our numbers we see a lot more variability from quarter to quarter between product lines and between countries. I'm not exactly sure what it is other than sort of the overall macro situation, but it's a little bit harder to predict our industrial business by product line and geography that it had been the last few years.

And I don't really see anything that's necessarily going to change that. There are some currency swings happening in some of the emerging markets and the news is kind of volatile in terms of business investment. So I anticipate potentially capital spending could still be a little bit variable as we look around the world in 2014.

Walter Liptak - *Global Hunter Securities, LLC - Analyst*

Okay. Okay, great.

Thanks for that color. Kind of sticking with your comments in Asia, what was the growth rate that you're expecting for Asia in 2014?

Pat McHale - *Graco Inc. - President & CEO*

We expect to dig out from a bad first quarter and end up in the low single digits.

Walter Liptak - *Global Hunter Securities, LLC - Analyst*

Okay. The ISM pulled back a little bit in China. I'm wondering what your kind of thinking about the tone?

I know it's a little bit lumpy with the projects getting produced in the fourth quarter, but what's your sense? Is China finally starting to get better?

Pat McHale - *Graco Inc. - President & CEO*

I don't really feel that yet, to be honest with you. We came off of a couple of really strong years in Asia-Pacific and now we've followed it up by a couple of really weak years.

So I'm not ready to say that things have bottomed and that they're going to turn the other way. But it's something that we're going to have to monitor.

We've got new products and we've got new people and we're working hard. But the overall environment is really hard to get your arms around over there right now.

There's the Chinese government data that comes out and then there's our view by end market on the ground. Those don't always line up exactly.

Walter Liptak - *Global Hunter Securities, LLC - Analyst*

Okay. And I had just a couple of minor things, on page 11 at the bottom you call out a $10 million divestiture cost, is that a banking fee?

Jim Graner - *Graco Inc. - CFO*

The majority of it, yes.

Walter Liptak - *Global Hunter Securities, LLC - Analyst*

Okay, and will that be netted with the gain or is that going to roll through on the income statement?

Caroline Chambers - *Graco Inc. - VP, Controller & Information Systems*

We've been including all those kinds of costs in our acquisition divestiture cost line that we've been calling out every quarter, but ultimately it will all roll together on the same line in the P&L.

Walter Liptak - *Global Hunter Securities, LLC - Analyst*

Okay. And in the last one, you mentioned that you're investing in at least DC and I wondered what the strategy was from it?

I wasn't sure if I caught the comment, I thought I heard that there was going to be a cost savings because of it. I wonder if you can just provide some more color?

Pat McHale - *Graco Inc. - President & CEO*

No, we're going to have access to that facility in the middle of the year and we'll be $1 million to $2 million to get it up and running. We'll have CapEx, new automated equipment in there probably in that $5 million to $8 million range for the year.

And then we'll have a annual operating costs of about $3 million. The situation we're at is that our factories are pretty much all full and generally speaking we have our distribution centers attached to our factories sharing the same footprint.

So rather than doing a multiple capital expansion project here the next couple of years and having to expand three or four of our factories, we made the decision to centralize our distribution operations close to our Rogers, Minnesota location where we build our contractor equipment. The majority of the volume comes out of, in terms of the volume by Q comes out of the contractor business, so having that centralized warehouse nearby there will minimize our transit costs and then we'll be able to take the distribution out of our other facilities and free up all of our facilities for manufacturing growth without having to do a bunch of capital investment.

So we did the work and this really turned out to be the best ROI. And it's really driven by growth, not cost savings. Hopefully, we'll get some efficiencies with everything together but that's not the main driver.

Jim Graner - *Graco Inc. - CFO*

And so, Walt, it is the most efficient from a CapEx point of view as far as building costs. But it will have incremental cost that go with it.

Walter Liptak - *Global Hunter Securities, LLC - Analyst*

Okay. Okay, great. Thanks, guys.

Operator

Charley Brady, BMO Capital Markets.

Charley Brady - *BMO Capital Markets - Analyst*

Just first on the liquid finishing dividend, I just want to make sure I'm very clear on this because I'll have to excuse the consensus numbers. Are you saying take it out exactly the -- because you had a couple of quarters where you bumped it up last year, are you saying that those numbers repeat or are you telling us it's more linear than that?

Caroline Chambers - *Graco Inc. - VP, Controller & Information Systems*

We're going to try to model it so that the quarters are equivalent. Obviously, depending on timing of what happens it could change but that's --

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Pat McHale - *Graco Inc. - President & CEO*

The equivalent was 2013, so where we bumped it up in 2013 we'll bump it up again in 2014.

Charley Brady - *BMO Capital Markets - Analyst*

Okay. All right. Fair enough.

And just on contractor margin. I just want to be clear on that, you're still expecting to settle the other expenses that are being put in, some product rollout stuff, margins are up year over year?

Pat McHale - *Graco Inc. - President & CEO*

I would expect contractor equipment division will have growth and improvement in margin in 2014 versus 2013.

Charley Brady - *BMO Capital Markets - Analyst*

All right. And then on the industrial with the acquisition, is there any margin headwind because of the acquisition on industrial in 2014?

Jim Graner - *Graco Inc. - CFO*

Not to the point that it'll be significant. It might be a 0.5 point.

Charley Brady - *BMO Capital Markets - Analyst*

Great. Thank you.

Operator

Matt Summerville, KeyBanc.

Matt Summerville - *KeyBanc Capital Markets - Analyst*

Can you talk about the airless line you're launching? Is that just solely focused on the pro paint channel or is there something similar coming in home center? And I guess from an ASP standpoint, how does this product or how will this product compare to the legacy line that's currently in pro paint?

Pat McHale - *Graco Inc. - President & CEO*

We've got about 50 significant part numbers that are being refreshed and launched this year. So it's a fairly broad-based offering that we're going to have.

I don't think it's going to change ASP too much but what it does do is it makes sure that we maintain our technology leadership. We were light on our contractor equipment, new product launch in 2013, and with the market coming back we think the timing is right to hit it with some exciting refresh acrossed the majority of our professional electric and gas powered airless paint spray line.

So it's going to be good for building excitement, it's going to be good for keeping our leadership position. We expect the environment to be good so it should help us grow.

But in and of itself it's not a huge growth driver of the business. The underlying economy is going to be the most important.

Matt Summerville - *KeyBanc Capital Markets - Analyst*

And then you mentioned throughout that new product development and marketing spend you highlighted some of the specific initiatives that you're focused on for 2014. Is there a way to better quantify what you're budgeting in terms of that incremental spend in those areas?

Jim Graner - *Graco Inc. - CFO*

So it's about let's say 30 people, and if you take the average cost of 30 people at $125,000 you get the kind of dollar number you can add to our expense.

Matt Summerville - *KeyBanc Capital Markets - Analyst*

And then with respect to just kind of non-residential market, Pat, can you provide some thoughts in terms of what you're seeing there?

Pat McHale - *Graco Inc. - President & CEO*

Here in North America we're expecting a slight improvement. Not a dramatic uplift in terms of the non-residential environment here.

Around the rest of the world, again, it's spotty. There are areas where I see lots going on and there are areas that look pretty dead.

So I think net-net it's going to be an okay environment outside the US. And, again, non-residential in the US is just going to be just okay as well.

Matt Summerville - *KeyBanc Capital Markets - Analyst*

Got it. Thanks, guys.

Operator

Jim Krapfel, Morningstar.

Jim Krapfel - *Morningstar - Analyst*

Over the intermediate term do you think it's fair to say that contractor segment margin within the Americas, I'm sorry revenue within the Americas will grow at a similar rate to US housing starts, or would you expect new products to drive above market growth?

Pat McHale - *Graco Inc. - President & CEO*

It's tough to make that tie. When you think about how our contractor business in the Americas works, first of all we've got the split between the home center and the pro paint and there are different dynamics, of course, that drive each of the segments.

Home center business tends to be less driven by new construction and is more by repair, remodel, and repaint, people investing in their homes. When you take a look at the pro side, that's not even clearly aligned with any particular market segment.

We sell painting equipment to paint contractors and they can use it to paint really whatever they want. It could be for a residential, new construction, it could be for commercial, it could be for a variety of different infrastructure projects.

So we have no real way to track that, but I think it's really a combination of what's the environment, remodel, repaint, commercial and residential. And there's some sort of a blend in there but I don't think there's a formula you can use.

Jim Krapfel - *Morningstar - Analyst*

Okay, that's helpful. And then the contractor segment operating environment, I think a year ago, maybe nine months ago you said the segment operating margins could reach mid-$20 millions if and when housing starts exceed $1.5 million. Is that something you still foresee?

Jim Graner - *Graco Inc. - CFO*

Yes, we're still comfortable with that. Pat talked earlier on 2014, so we're targeting a 2 percentage point improvement in operating margins in 2014 and we're still at this point short about $60 million in legacy product sales from the peak in 2006 in North America and about another $30 million short from the peak in Europe.

So, again, those tended to be the higher-priced units, the higher-capacity units, and we are seeing a move in acceleration and purchases of those units. So all of that bodes well for the operating margins in that segment.

Jim Krapfel - *Morningstar - Analyst*

All right, thanks.

Operator

Liam Burke, Janney.

Liam Burke - *Janney Montgomery Scott - Analyst*

Pat, you talked about early successes in the adhesives business. Is it just in North America or is that been rolled out worldwide?

Pat McHale - *Graco Inc. - President & CEO*

We're just starting to get some traction outside the US. We put our main, dedicated resources for 2013 were here in the US.

We did a little bit outside the US. Based upon the success that we've had we are ramping up our investment in that particularly in some headcount outside the US.

So I'd say if you take a look at the actual financial results, probably 85% is US-based but we have been introducing the product concept around the world to material suppliers and others, and so we're not starting out with no traction for 2014. We've got a little bit of traction internationally.

Liam Burke - *Janney Montgomery Scott - Analyst*

Okay. And on the powder coating side when you bought the business there hadn't been a lot of distribution out of Asia-Pacific. Have you been able to pick up the slack there and increase distribution there?

Pat McHale - *Graco Inc. - President & CEO*

Actually, Asia-Pacific has been a great region for the powder business for number of years. And they continue to be fairly optimistic about the end market opportunities there going forward.

We have globally been working the Graco, I'll say the Graco team, and then the Graco Gamma team have been working together on the commercial side, mapping out the world and trying to figure out where opportunities are for us to share distribution. And we've made some progress on that over the course of the year.

I think we'll make more in 2014. The reality is that a lot of the powder business is project-based and it's systems based and it's going to remain a direct sale. And so there's going to be some opportunity for us to expand distribution but it's not going to look like a Graco business when we're done with it from a channel standpoint.

Liam Burke - *Janney Montgomery Scott - Analyst*

Good. Thank you.

Operator

(Operator Instructions) Joe Ritchie, Goldman Sachs.

Joe Ritchie - *Goldman Sachs - Analyst*

First just a quick question on contractor. Can you tell us what was going on in Asia-Pac this past quarter? It looks like it was pretty weak, so any specifics around that would be helpful.

Pat McHale - *Graco Inc. - President & CEO*

Yes, we're not happy with our recent performance in contractor over there. It's hard to get your arms around it.

Obviously, there's not really a market, we're building the market as we go in most of that territory. So publicly available data that can help us figure out exactly what's going on is nonexistent.

But one of the things that we're seeing, particularly in China, is a lot of the construction now has moved really from the main historical areas out to the second and third tier cities. And we believe that we're not positioned well enough with distribution in some of those markets.

So that's going to be a big focus for us in 2014, making sure that we're building our distribution channel out off the coast and where the action really is. In addition, we are seeing more local players at the entry level space in that market. As of yet, I can't determine whether that's good for us or bad for us.

You can make a case that they could be chipping away at our low-end business. You could also make the case that we've convinced enough of the market the benefits of spray that other people are seeing a opportunity.

So that's going to have to play itself out. We're watching that closely.

In general, we think our strategies are still right. But we certainly didn't have the kind of performance year in Asia-Pacific in contractor in 2013 that we expect going forward.

Joe Ritchie - *Goldman Sachs - Analyst*

That's really helpful color, Pat. I guess as you think into 2014 then, is there additional investment that you're going to be making then, and have you quantified that investment in that region?

And then as it relates to your guidance, I know that you guys have specified contractor up double digits in the Americas, but the other regions are going to grow slower, so contractor in total? Are we looking at closer to high single-digit growth then in 2014?

Pat McHale - *Graco Inc. - President & CEO*

I would say that that's probably a good number. In terms of additional investment in Asia-Pacific for contractor I don't think it should be significant.

I think it's really an issue of us deploying the resources that we already have in place slightly differently than we have again focusing them on Tier 2 and Tier 3 cities. There could be a few people added here or there but I don't think it's anything that you're going to notice.

Joe Ritchie - *Goldman Sachs - Analyst*

Okay. And then maybe, Jim, one question for you on contractor this year.

You saw some pretty significant growth that came out of the home center channel. Could you tell us how much of the mid-teens growth came out of home center because clearly that was probably coming in at much lower margin and I'm just trying to get a sense for how I should think about the incrementals on organic growth next year because it would seem to me that the incrementals were well above 50% in 2013.

Jim Graner - *Graco Inc. - CFO*

Your observation is right. The home center business did grow about double what the paint channel grew and it has improving operating earnings as we get more volume.

But it is a little drag on the overall. But, again, we're comfortable in our call for our 22% operating earnings return for the full year of 2014.

Joe Ritchie - *Goldman Sachs - Analyst*

Okay. All right, thanks, guys. I'll get back in queue.

Operator

If there are no further questions I will now turn the conference over to Pat McHale.

Pat McHale - *Graco Inc. - President & CEO*

All right, well, thank you everyone for your time this morning. Have a good day.

Operator

And this concludes our conference for today. Thank you for participating and have a nice day. All parties may now disconnect.
