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GGG - Q3 2013 Graco Earnings Conference Call

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OVERVIEW:

Co. reported 3Q13 sales of $277m and net earnings of $56m or $0.89 per diluted share.

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PRESENTATION

Operator

(Operator Instructions). Good morning, and welcome to the third quarter, 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 U.S. or Canada. The dial-in number for international callers is, 303-590-3030. The conference ID number is, 4643781.

The replay will be available through October 27, 2013. Graco has additional information available in a power point slide presentation which is available as part of the web cast player. At the request of the Company, we will over the conference up for Q&A 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 purpose of 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 at www. Graco.com,and the SEC's website at www.sec.gov.

Forward looking statements reflect managements 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. I will now turn the conference over to Ms. Caroline Chambers, VP, and Controller. Please go ahead.

Caroline Chambers - *Graco, Inc. - VP, Controller*

Good morning, everyone. I am here this morning with Pat McHale, Jim Graner, and Christian Rothe. I will provide some top level discussion on our overall financial results from the third quarter and then we will 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 third quarter in our usual format.

Sales this quarter totaled $277 million, an increase of 8% from the prior year with varying trends by division in regions. Sales in the contractor segment grew by 24%, along with modest increases in the Industrial and Lubrication segment.

Regionally, sales in the Americas grew by 15%, sales in EMEA increased by 8%, or 4% the consistent translation rate, and sales declined by 9% in Asia Pacific, or 6% at consistent translation rate. Pat will give more detail by region and segment in a moment.

Net changes in currency translation rates from the prior year did not have a significant affect on sales or operating results for the quarter overall. Unfavorable currency translation change from Asian currencywas nearly offset by favorable currency translation from the Euro.

A table showing impact of volume, acquisitions and currency by segment and region is included on page five of the slides. Net earnings total $56 million, or $0.89 per diluted share for the quarter.

Page 8 of the slide deck provides a quarter over quarter overview of changes in operating earnings. Gross profit margin as a percent of sales was 54.5%for the quarter, consistent with a prior year.

Realized pricing and manufacturing cost improvements were offset by significant growth in the contractor segment during the third quarter and other changes in mix. Operating earnings improved in the Industrial and Contractor segments, though were flat in the Lubrication segment.

Acquisition/divestiture cost were insignificant in the quarter, as compared to $3 million for the third quarter last year. Other unallocated corporate expenses were consistent with the prior year and consistent with our expectation that they will be in the range of $5 million to $7 million per quarter, excluding acquisition and divestiture expense.

Other income includes dividends from the liquid finishing business of $9 million for the quarter, and $24 million year to date. Once again a brief reminder on the background of this investment and the dividends.

The Liquid Finishing business was purchased in April 2012. It is reflected as cost investment on our balance sheet and the financial results are not consolidated. Under terms of the Hold Separate Order from the FTC, we cannot exercise direction or control 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 in Graco's income statement. To reduce cash and undistributed earnings in the Hold Separate operations a higher level of dividends were distributed in the second and third quarters this year as compared to the usual $4 million received in previous quarters.

We expect dividends to be approximately $4 million in the fourth quarter. We have not yet received the final order from the FTC requiring the 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 was 24% as compared to 32% last year reflecting the effect of the federal R&D tax credit that was not renewed until the first quarter 2013. The effect of the higher level of after tax dividend income received from the Liquid Finishing businesses is held separate. Additional benefit from U.S. business credits and deductions and greater foreign earnings that are taxed at lower rates than in the U.S.

We have included our usual slides about segment results in the slide deck, starting on page 12. Net cash provided by operating activities was $81 million for the quarter, with changes in working capital in line with the business volumes, and consistent with prior quarterly trends.

Capital expenditures were $6 million, and we pay dividends of $15 million. We resumed modest share repurchases earlier this year with $28 million of repurchases through the end of the third quarter.

Our outstanding long-term debt was $404 million at the end of the quarter, with net repayments year to date of $152 million. We anticipate the total future cost of a divestiture will be approximately $10 million, though the timing of expense and the final amount will be affected by the sale and regulatory review process and duration.

The tax rate for the fourth quarter is expected to be at 28% or 29% and the full year rate is expected to be approximately 27% to 28%. Capital expenditures for the year are expected to be in the range of $20 million, and we expect to continue a moderate rate of share repurchases in coming quarters.

With that, I will turn the call over to Pat for more comments on our quarter.

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

Thanks, Carolyn. Good morning. This morning I will provide some commentary on the trends we saw in our business in the third quarter and our outlook on the fourth quarter. I will also touch on some early thoughts on 2014.

Overall sales growth for the third quarter was solid at 8% and we posted another record for third quarter sales. Similar to the last couple quarters we still are not hitting on all cylinders. The America's outperformed our own expectations due to the contractor segment performance.

Asia Pacific under performed in both industrial and contractor segments and there were some bright spots in the EMEA region. I will call each of these out as we go through the recap.

From a profitability standpoint, we set a record for third quarter net income for the Company. As you know that figure is impacted by the dividends of the Hold Separate business. The more appropriate earnings figure for the core Graco business is operating earnings which grew by $13 million compared to the third quarter of last year, and an increase of 24%. This is on sales growth of $21 million.

If we adjust for the $3 million in acquisition expenses that were in the third quarter of 2012, incremental margins are near 50%. Now I will walk through each of the regions and segments. My comments are based on year-over-year performance for the quarter and year to date on a cost and currency basis and exclude the impact of acquisitions.

First, Asia Pacific. Overall Asia Pacific was down 6% versus Q3 2012 and performed worse than anticipated in the quarter. Year to date performance is negative 3% which is also worse than we expected it to be at this point of the year. Our Asia Pacific team continues to find the macro environment challenging, although we do have product lines and are performing well.

Geographically we are seeing strength in Japan and southeast Asia while China and India remain weak. We also noted deterioration in Australia in the third quarter due to mining activity levels dropping.

As we discussed in the second quarter call and remaining relatively unchanged in Q3, currency head winds (inaudible) profitability somewhat in this region. The industrial segment in Asia Pacific declined 9% in the quarter and our contractor segment decreased 7% and now is flat on the year.

In Contractor, we continue to see good growth and texture and (inaudible) products, offset by weakness and paint equipment. Our lube business returned to growth in Asia for the first time in a year. We saw significant dropoff in second half of 2012 due to weakness in certain key mining accounts.

Those comps are now easier and we finally saw some orders from those accounts this quarter, although at reduced levels. Demand continues to be highly variable from country to country and across product lines for our Asia Pacific region. We are seeing pockets of growth, but it is difficult to point to many clear, upward the trends.

Moving on to EMEA. We grew 4% in EMEA in the third quarter and are now showing positive organic growth year to date. For the legacy Graco business we were flat in the west and our growth came from the east.

The power business saw the reverse situation with several large powder systems orders shipping into the west during the quarter. Similar to what we are seeing in Asia, there is a high level of variability in the performance of products and geographies from quarter to quarter.

In the case of EMEA however, the foxes strength are winning the day and resulting in overall growth for the region. Every segment is either flat or up year to date in EMEA, not easy accomplishment in this economic environment.

Moving on to the America's. Our contractor segment remains strong with solid double-digit growth during the quarter. Both the paint store and home standard grew at double-digit pace in the third quarter and those customers saw strong sell through. As such, inventory levels in the channel appear to be appropriate.

So far this year the base business grew in the low double digits with the remainder of the growth coming from new products, increased SKU's with certain retailers, and selling initiatives. The strong year over year increase in contractor sales has resulted in a higher than anticipated growth incentive achievements. This was a slight drag on profitability during the quarter and will continue to be a factor in the fourth quarter.

Our industrial segment in the Americas grew at a 3% pace in the third quarter identical to the first half and in line with our expectations as customers remain cautious on capital spending. Our Lubrication segment in the Americas was flat in the third quarter, similar to the pace we have experienced throughout the year. This is the result of the ongoing trend in the Americas of growth in our legacy vehicle service business offset by declines in our industrial lube business.

Industrial lube is impacted by lower demand in both on-road and off-road mobile applications. In the last few months we made good progress on some specific, long cycle selling initiatives in Lubrication segment both domestically and internationally. We have also recently launched additional new products. We remain positive on the growth potential for this segment for the long-term.

Before moving on to our outlook for the fourth quarter, I would like to give a recap of some general thoughts and trends about our industrial business worldwide. Right now we are seeing a mixed bag worldwide and high variability between product lines and geographies. As stated a moment ago we see generally cautious spending on capital expansion projects globally.

This has resulted in a modestly unfavorable change in product mix as product lines associated with capital expansion have been soft. In addition, profitability for industrial has been impacted somewhat by the currency head winds in Asia that began in the second quarter and continue today.

Automotive production levels are relatively healthy in the Americas and Asia Pacific, but they are very soft in Europe. Graco sales by product line have been mixed in automotive. Our fluid dispense products have been generally strong, while finishing applications aren't as favorable against several years of robust growth.

The fall market has been solid globally as has our Sanitary business, which is small but growing. Our new Hot Melt initiative is meeting expectations and adding some incremental revenue to our top line. On the negative side, mining, ship building, container manufacturing and heavy machinery are generally soft.

Now, for some comments about our outlook. Our outlook for the year 2013 is relatively unchanged from last quarter with one exception. Overall, we had expected full year growth in every region. Year to date we are 3% below the prior year in our Asia Pacific region, so we now believe that full year growth is unlikely.

We do believe we can grow this region in the fourth quarter, however, against the easiest comp of the year, albeit at a low, single digit pace. In the Americas, the contractor segment should grow double-digit's in the fourth quarter but the rate of growth will decelerate as Q4 2012 was a pretty strong quarter.

I'll also note the contractor spending in Q4 will be up as we prepare for a number of new products that will launch in the first half of 2014.

For our Industrial and Lubrication businesses in the Americas we continue to expect low single digit growth. We also expect growth in EMEA in Q4 but also at a low, single digit pace.

Our factories continue to perform well and incremental profit on our sales growth this year has been outstanding. 2013 will be a record year for Graco in sales, operating earnings, net income, and diluted earnings per share.

We've had our share of struggles no doubt, but the overall Company performance this year has been very strong.

Initial thoughts on 2014. For 2014 we plan to achieve growth in every segment and every region of the world. Our plan relies on a continued focus on new products, new markets, expanded distribution, and end user conversion. Most of the resources we need are already in place.

Where there are gaps, and that is primarily in Asia Pacific and South America, we will be adding resources to help achieve our goals. Our product development spending is already pretty well aligned with our business plan and we expect spending will remain at similar levels to 2013 with the exception of wage inflation.

Our new product pipeline is solid with a greater focus on incremental opportunities more than product upgrades. We expect the U.S. construction environment will continue to improve and our contractor business will grow nicely again in 2014. There isn't much more I can offer on 2014 at this point.

A few comments on Liquid Finishing divesture process. The government shutdown did affect the personnel at the FTC that are working our case so there are very few updates to share. The business continues to perform well as evidenced by $9 million in Hold Separate dividends that flowed through to Graco in the third quarter.

When the time comes to sell the business we are prepared to go to market quickly. The ongoing question from our shareholder base, of course, is what we do with the cash. Overall, we feel that our organic growth initiatives are well funded today. Our priority has been, and will be, to find good M&A opportunities, but the key is to remain disciplined in our approach. With or without acquisitions, though, share repurchases will be considered in the mix.

This concludes my prepared remarks. Operator, we are ready for questions.

QUESTIONS AND ANSWERS

Operator

Thank you, sir. (Operator Instructions). Our first question comes from the line of Joe Ritchie, with Goldman Sachs. Please, go ahead.

Joe Ritchie - *Goldman Sachs - Analyst*

Hi, good morning, everyone.

Caroline Chambers - *Graco, Inc. - VP, Controller*

Good morning.

Joe Ritchie - *Goldman Sachs - Analyst*

Pat, on your comments regarding construction spending being up, or contractor spending being up in the fourth quarter due to the new product launches, there has been a lot of volatility in the margins historically because of that fact. Can you quantify how much of a head wind, or how much spending is going to be up in 4Q?

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

I am not sure exactly. I would say a good number to use would be between $1 million and $2 million.

Joe Ritchie - *Goldman Sachs - Analyst*

Okay. Helpful. You mentioned earlier how your investor base is clearly interested in what you are going to do with the cash an eventual divestiture of the liquid business. Can you talk a little about the pipeline opportunities and also the timing? For example, there is a view that if you were to sell liquid today, or had the opportunity to, that it would have a dilutive impact on your earning stream. However, it doesn't seem like there is a lot of earnings that are really coming through today on the liquid side. So just help us understand the potential accretive opportunity if you were to divest liquid and to be able to put that cash to use on an accretive opportunity.

Jim Graner - *Graco, Inc. - CFO*

So, Joe, this is Jim Graner. I will answer the last part of that question while Pat thinks about the pipeline. On page four of the slides that accompany the call we break out the impact of the dividends on our EPS on the bottom. You can see there for the quarter we got $9 million, or $0.14 and year to date to $24 million, or $0.38. So those earnings will disappear. The dividend stream will disappear when the sale takes place. I will let Pat comment on the pipeline of what we are looking for potential acquisitions.

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

We have a number of people working in different areas we have targeted for interest. We have had some things to look at and I would say our pipeline is at least average and maybe a little better than average. Probably more driven by the fact we have more sources on it than we have in the past .

One of the things we do see is we see people paying up pretty significantly for assets out there. We are not just going to go buy something just to fill a hole. We want to make sure we get a good ROI. We are a cash on cash kind of company. We want to make sure any deal we do we can add some value to. I don't think it is a given at this point we will be able to put all of that cash to work on M&A and that's why share repurchases are and will remain in the mix, but we will do what we can to find an opportunity that we think our shareholders would be pleased with.

Joe Ritchie - *Goldman Sachs - Analyst*

That's helpful color, Pat. One clarification, Jim, on EPS impact on slide four, that excludes the interest costs associated with the current debt levels, correct? That number, $0.38 cents wouldn't go away. It would be a number a little bit lower than that, correct?

Jim Graner - *Graco, Inc. - CFO*

Correct. We have today about $100 million borrowed at LIBOR, plus a few points, so we will have a million or two on an annual impact and reduction and interest expense. As you know, cash balances these days don't earn what they used to. You are correct in your calculation. It will be somewhat less than the $0.38, but not significantly.

Joe Ritchie - *Goldman Sachs - Analyst*

Okay. Thanks.

Operator

Our next question comes from the line of Mike Halloran, with Robert W. Baird. Please, go ahead.

Mike Halloran - *Robert W. Baird - Analyst*

Good morning, everyone.

Caroline Chambers - *Graco, Inc. - VP, Controller*

Good morning.

Mike Halloran - *Robert W. Baird - Analyst*

Piggy-backing on the contractor margin question there, could you maybe just talk about the moving pieces in the third quarter for the contractor margins? If there was any residual impact there from new product introductions, mixed swings and things like that?

Jim Graner - *Graco, Inc. - CFO*

Yes , so on a mixed basis Pat talked about the SKU's being higher in the Home Center with one Home Center customer. As you know the Home Center tends to sell our lower priced equipment and the margins for that are less than ours. We are still not seeing the swing in our overall business to the bigger units. The small units continue to dominate and as such on a sequential basis there wasn't much margin improvement. We did have a little bit of catch up to do on our accruals for those things that are calculated on growth. Sales incentive and customer incentives . So that maybe took one or two points out of the current quarter operating profit as we caught up the year to date numbers. Should have less impact on the fourth quarter. The fourth quarter is our seasonal low for this business and you generally see a dropoff in operating profits as a percent of sales and we are expecting that same trend to happen this year.

Mike Halloran - *Robert W. Baird - Analyst*

Makes sense. And then on the industrial side of the business, maybe just some thoughts on demand tracked through the quarter. Any shifts or variability you saw sequentially? I know you say the macro is still mixed on that side, but I wouldn't mind hearing how things have tracked over the last few months.

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Jim Graner - *Graco, Inc. - CFO*

Yeah, so I will give you an over view in total of our order rate. September was a strong order rate for us on a weekly basis that equaled our strongest period during the year. The first three weeks of October look better than August and July. Both of which I think are slightly positive given that the contractor business trails off sequentially as I mentioned earlier. What we are seeing is a replacement of that, I will call it, sequential decline in contractor order rate by industrial and industrial and in particular modest growth in EMEA. So the mix, the volume is tracking sequentially okay with industrial picking up seasonality drop in contractor.

Mike Halloran - *Robert W. Baird - Analyst*

And then last one from me just on the tax rate for next year. Assuming that there are no more dividends associated with the ITW piece, should we be expecting this to track back toward that historical norm in the low 30s?

Christian Rothe - *Graco, Inc. - VP, Treasurer*

This is Christian. Yes, it should be in the 32% to 33% range. The big assumption around that is that the R&D tax credit is renewed which it hasn't been renewed yet. If that doesn't happen you will see about a percentage point increase in the rate.

Mike Halloran - *Robert W. Baird - Analyst*

Makes sense. Thanks, everyone.

Operator

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

Charles Brady - *BMO Capital Markets - Analyst*

Thanks. Good morning, folks.

Jim Graner - *Graco, Inc. - CFO*

Good morning.

Charles Brady - *BMO Capital Markets - Analyst*

On the contractor business, you talked about new product roll out. I am just wondering timing wise when that hits in 2014? I am assuming it is a normal seasonality of when you roll stuff out, but is there anything, out sized product, new product coming out that might be larger than normal?

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

We think it will be a good new product year in contractor and probably a stronger, well not probably, for sure a stronger year in 2014 than 2013 for us. The majority of those products will launch in the first half of next year. We typically will stagger our launch between the regions just so we can smooth production. You should see some of those in the first quarter and some of those in the second quarter.

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Charles Brady - *BMO Capital Markets - Analyst*

Great. And back on the mix question again, I am just wondering if we can get more granular. If you dice it between low, medium, high margin or low, medium, high price, can you give us a sense of how that mix segments out? Normalized market is a third, a third, a third roughly. It has been creeping up more toward the higher end, but I'm wondering where we are today on that, and is it still moving toward the higher end or is it stayed where it is?

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

Well, there is some variability in there just because of some of our sales initiatives. We have had some good selling initiative and SKU expansion within the Home Center channel. So the mix issue in contractor, of course part of it will be market driven, but also part is driven by that dynamic. We have had good success in the Home Center channel this year and as Jim has said earlier that has helped keep our product mix leaning more toward the smaller units.

Charles Brady - *BMO Capital Markets - Analyst*

If we look at the professional side and focus on a professional painter for a second, are you seeing those type of painters migrate and have more acceptance to buy a higher market product or are they still a bit more hesitant to go that far out?

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

Our product lines that are larger sprayers are definitely seeing improvement in those. There is no doubt about it. They are no where back to the levels they were when the housing market was at it's peak, but certainly those production lines are running a lot stronger than they were running a couple years ago.

Charles Brady - *BMO Capital Markets - Analyst*

That's great color. Thanks.

Operator

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

Matt Summerville - *KeyBanc Capital Markets - Analyst*

Good morning. Along the lines of the last question, you guys have been pretty clear historically that it is much more accretive to profitability when the mix of pro-paint is moving upward relative to the Home Center. If you go back and look just in the U.S. business, Pat, over the last cycle maybe, where is the mix today in the U.S. in terms of pro-paint versus Home Center as a percent of revenue and where was it when it was most lucrative to Graco in the past is what I am trying to ask.

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

I will let Jim chime in if he has any data, but I will have to go back and do some math on that. We had a peak trough and then improvement situation in terms of how that shook out. Our home center business declined really more due to decisions made in the 2007, 2008 time frame. While the housing market was coming off its peak our Home Center business definitely experienced a trough in that point of time where our Home Center business had a peak that was back in the 1999, 2000, 2001 time frame. It hasn't lined up with market dynamics. It had more to do with things happening with particular customers. I don't have a calculation for you. I will let Jim chime in if you have anything more concrete than that.

Jim Graner - *Graco, Inc. - CFO*

Matt, we are comfortable with our nice increase in the dollars of profits in this segment tracking along with the sales increase. Your question is more in the expansion of the percent, and right now we are on the spurt here of nice growth in the Home Center business with additional fuse that we talked about for the last couple quarters. We are seeing a mixed change in the professional, just the size of the increase in the Home Center being more than professional, it'sdampening our percent of sales.

Matt Summerville - *KeyBanc Capital Markets - Analyst*

Okay. With respect to the final decision order and that process, I think, Pat at the last conference call, you were a little optimistic and said there were two issues out there. One of which you had come to an agreement on, or at least put it behind you. And then there is still one issue which I guess I was under the impression was the least complicated of the two. Perhaps can you talk about where that process is? I get the government was shutdown , but do you have any idea when you get the final DL?

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

I don't think we do. If we would be guessing we would be guessing wrong a lot. We prefer not to guess. Until the government got shutdown there was work being done. It is not like it is sitting on a back burner somewhere and no one is working on it. I know the folks in the FTC that are working on our case are engaged in the issue it is just taking longer than I guess any of us thought.

Matt Summerville - *KeyBanc Capital Markets - Analyst*

One last question. With respect to China, I don't know if you've been over there recently but can you provide a more detailed assessment than what you are seeing on the ground there on a day-to-day basis? What you are seeing in terms of credit availability, what your customers are telling you, what is the state of discussions you are having with customers on their propensity to expand capacity as we head through 2014?

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

We will give a couple of different data points here. I will give you observations and then Jim can chime in. We were over there together in late August is the time we are on the ground. We actually had our AP folks here about two weeks ago for our 2014 planning session for a week so we've had a lot of interactions. When you are over there, there is still lots of activity. There are lots of things going. The economy to me doesn't look like it is in the tank. But I think what has happened is that particularly in a few industries they had a pretty big in rush of capital on some capacity expansion and they need to absorb that. So the GDP numbers still look okay. The economy looks like it is still ticking along. My belief is that the story there is still good over the longer term. People wish it was a straight lineup, and it is not.

It is going to be choppy and there will be times when they are expanding industries and putting new lines in and there will be years here and there where they absorb that capacity through demand. I think we are in one of those periods right now. I am not overly negative about it and I think if we have a little patience things will be fine. I will let Jim give you his comments.

Jim Graner - *Graco, Inc. - CFO*

We were impressed that there are still cranes . There are office buildings going up. There are factories going up in the industrial parks that we visited. So we think there is opportunities and the government still wants to provide housing for the vast majority of the people there and those activities are progressing. As Pat said, we think it is a good economy and we are trying to make the call quarter by quarter here and we just got burned here a couple of quarters. We're still optimistic on 2014.

Matt Summerville - *KeyBanc Capital Markets - Analyst*

Thanks, guys.

Operator

Our next question comes from the line of John Franzreb, with Sidoti & Company. Please go ahead.

John Franzreb - *Sidoti & Company - Analyst*

Sticking to the Asia Pacific region, the relative under-performance there, would you attribute that mostly to what is going on in the mining market in Australia?

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

That's a piece of it. It is not just the money market in Australia. We have seen pockets of weakness in China and India as well and certain end markets and across certain product lines. It is not an across the board kind of thing where every product line in China is struggling, but we do have some product lines particularly associated with capital expansion projects that have been weak. So I think it is more of a mixed bag than that. I don't think it is just as simple as saying it is one industry.

John Franzreb - *Sidoti & Company - Analyst*

And regarding the lube business, Pat, it seems like it is stuck at the current threshold as far as revenue is concerned. Are there any potential carrots you can point to that might get that business humming again? Can you put some color on what you think the growth opportunity is in lube going forward?

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

My expectation for lube over the next number of years is that it should be able to put up organic growth numbers that are in the 10% range. Certainly we are not doing that this year, but the new products we just launched we are pretty excited about, and as I mentioned on my prepared comments, we have been working on some Song initiatives that have a long cycle to them and some of those appear to be gaining traction. I haven't lost my belief that that's still a 10% kind of organic growth story over the longer term both with products and with Song initiatives. They have actually done some things that are positive this year. Unfortunately with some of the big drop-off's in our key mining accounts it shows as flat. So you can say, gee, they are stuck and they haven't done anything, but on the flip side if you look at where the businesses have come from they have added business that have filled some holes from the mining drop-off's. Generally, although I am not happy about them being flat, I am satisfied with where we are. I'm still positive about where we are going.

John Franzreb - *Sidoti & Company - Analyst*

So if you x'd out the mining dropoff in lube, would the business be performing at a high single digit rate?

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

I haven't done that calculation, so I am not going to comment.

THOMSON REUTERS

John Franzreb - *Sidoti & Company - Analyst*

Okay. Thank you very much, guys.

Operator

Our next question comes from the line of Jim Krapfel, with Morningstar. Please, go ahead.

Jim Krapfel - *Morningstar - Analyst*

Good morning, everyone.

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

Good morning, Jim.

Jim Krapfel - *Morningstar - Analyst*

What gives you optimism long-term in regards to industrial lube? What applications are you most excited about?

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

Well, you know, we've got a pretty broad product line now. We made a couple of small acquisitions here six or seven years ago and the product line had a lot of gaps and a lot of holes and it needed some quality improvement. We spent a lot of time getting the product line in order investing in engineering. We are now launching products that are incremental to that. We've basically fixed the product offering that we have and we are launching new things. I like the product portfolio. I think it is strong. I think it will continue to be strengthened over time and we're going to be in a positive position from a product standpoint. The challenge we have in that market place, where we have very low share is the fact that the leaders are entrenched in the specs and to try to knock somebody out of a spec takes a lot of work and a lot of time. That's what we are focused on right now. We are focused in particular in some of the energy markets; wind energy and the natural gas market. We are doing things in oil and gas, and I just think the Graco model works and we have patience and we are going to grind it out.

Jim Krapfel - *Morningstar - Analyst*

Okay. Thanks. And do you expect on a firm-wide level to keep your foot on the peddle when it comes to product development spend? Do you look at the vitality index at all?

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

I will let Jim kick in and give you a little about what we do in terms of that review. But my view is our current level of spending is appropriate. We may have more things on the margins we may want to invest in, but I think the number you see for us today if you adjust that by wage inflation is probably a number we will be around the next couple years.

Jim Krapfel - *Morningstar - Analyst*

Great. Thank you.

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

A major pull back or major expansion. Jim can talk about the vitality review we do.

Jim Graner - *Graco, Inc. - CFO*

Again, Jim, we are a cash on cash kind of measuring return here. So we have a process where we rate every project and every group on their expected revenue growth or achieved revenue growth and return on the investment. We are doing a little more now with respect to rather than product refresh we are doing more on incremental. So we are in the process of changing our metrics tohave two metrics. One is, I'll call it, the historical Graco metric on product refresh where we measure product growth over a three-year cycle. And it is compared to incremental products. We are thinking we are going change that to a six-year kind of measure. Once we have that completed you will see the vitality measures be a little different than we have been in the past.

Jim Krapfel - *Morningstar - Analyst*

Thanks. That's helpful.

Operator

(Operator Instructions). Our next question comes from the line of Liam Burke, with Janney Montgomery Scott. Please go ahead.

Liam Burke - *Janney Montgomery Scott - Analyst*

Thank you. Good morning, Pat. Good morning, Jim.

Jim Graner - *Graco, Inc. - CFO*

Good morning.

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

Good morning.

Liam Burke - *Janney Montgomery Scott - Analyst*

Pat, in the industrial segment you mentioned you saw growth or order increase in the powder coatings product line. How has that done in Asia Pacific? Have you gotten this I traction there?

Jim Graner - *Graco, Inc. - CFO*

So I think the comment was with respect to EMEA? Where we have growth in the west in powder?

Liam Burke - *Janney Montgomery Scott - Analyst*

Right.

Jim Graner - *Graco, Inc. - CFO*

We are seeing similar kinds of things. This year in the first half we had greater growth in the U.S. building off of what I'll say is our weaker position in the U.S. so we are pleased with that activity. And also we have some projects in backlog in Asia Pacific that we should get some revenue recognition in the fourth quarter. I would say our geographic mix is changing from when we acquired the business. More growth in the U.S. and more growth in Asia Pacific, and the comment Pat made was really with respect to the mix within the EMEA region.

Liam Burke - *Janney Montgomery Scott - Analyst*

On the Sanitary front I know it is a small part of the industrial business, but one of your growth engines. How is that progressing? Are you comfortable with how it has been developing?

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

We are real happy with how that is progressing both from a product portfolio standpoint and trying to build some specific channel. I will say our normal process distributors don't necessarily get into those accounts. Part of what we are doing is trying to build a channel worldwide of distributors that actually call on the sanitary end customers as part of their normal business model. Growth is good. Again it is still small, but we are pleased with that. Also from an M&A perspective that is one of the, I will call it, segments we would be interested in doing a deal if we could find the right one.

Liam Burke - *Janney Montgomery Scott - Analyst*

Great, thank you.

Operator

Our next question comes from the line of Kevin Maczka, with BB&T Capital Markets. Please, go ahead.

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

Thanks, good morning.

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

Good morning.

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

Pat, back to your comment on adding resources in Asia and South America, it sounds like your product development spend is appropriate. I don't think you have been capacity constrained and Asia pack is not growing right now. Can you say a little more about what you need to do to position yourself for the next few years in Asia and South America?

THOMSON REUTERS

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

We are not ill positioned in Asia by any stretch of the imagination, but it is a pretty big geography and we've got a lot of product lines and one of our goals has been to try to continue to specialize so we can have people that are deep in product categories and have them setting up channel partners that are also deep in those categories versus trying to have somebody carry a broad product offering and have it distributed. It does the same thing. So the additions I can envision for Asia Pacific in terms of sales resources in 2014 tend to be to support specialization initiative. South America is a little different. We covered that as an export market out of the U.S. with U.S. leadership for a longtime.

Effective January 1st we took a couple of our strong high performing folks and put them down in country from our European organization down into South America and we have given them the charter to go ahead and invest more heavily down there and let's try to get a higher level of growth. They have been doing their work the last 9 or 10 months to understand the market and our coverage and our opportunities. They have fairly aggressive plans in 2014 to get us more sales coverage down there. I anticipate we will be adding people as well. When I talk about resources in Asia and South America, I am really talking about sales people.

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

Thank you.

Operator

We have a follow-up question from the line of Matt Summerville, with KeyBanc Capital Markets. Please, go ahead.

Matt Summerville - *KeyBanc Capital Markets - Analyst*

Thanks. I just want to make sure I understand something. So, Pat, you were talking about incoming order rates or Jim, maybe, in the first couple weeks of October. Referenced July and August, talked about a pick up in industrial offsetting the typical negative seasonality you have in contractor. I guess I want to be sure of something. Are you expecting that that step up you're seeing in industrial completely offsets the normal fourth quarter seasonality?

Jim Graner - *Graco, Inc. - CFO*

No, not really, Matt. It is a slight positive on the industrial business and then on EMEA. The sequential on Asia was pretty flat, but there was a pick up on EMEA and a pick up on industrial.

Matt Summerville - *KeyBanc Capital Markets - Analyst*

Within Europe on the industrial side are there certain end markets that are driving that or is there something you are seeing more broad based? Is this projects that were deferred and now starting to hit the order book?

Jim Graner - *Graco, Inc. - CFO*

I will say it is just a modest improvement on the broad base of our product offering. There are some things happening in the Middle East that probably are spiking the current activity for the last few weeks. As those economy's or those governments calm down a little bit.

Matt Summerville - *KeyBanc Capital Markets - Analyst*

Got it.

Jim Graner - *Graco, Inc. - CFO*

I can't really pinpoint any specific thing that is happening in the industry.

Matt Summerville - *KeyBanc Capital Markets - Analyst*

Got it. That's all I have. Thank you.

Operator

Our next question is from the line of Jim Giannakouros, with Oppenheimer & Company. Please, go ahead.

Jim Giannakouros - *Oppenheimer & Company - Analyst*

Good morning, guys.

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

Good morning.

Jim Giannakouros - *Oppenheimer & Company - Analyst*

I just have one question on industrial margins and I'm sorry if I missed all of the puts and takes, but when you entered I guess after Q1 2013 we had 33.5 operating margin and I believe the sense was that you guys could do slightly better or hold that line for the remainder of the year. We have been trending down for the last two quarters. Outside of Asia pack industrial volumes being lower than expected, what do you attribute to that decline and how should we be thinking about when volumes normalize in Asia pack industrial and where you think things will sauce out in the near term there?

Jim Graner - *Graco, Inc. - CFO*

Jim, I did a little reconciliation and I will take you through that and then we will talk about what I think could change in the next quarter. Your comparison to the first quarter is what I did. I compared the third quarter to the first quarter. In the industrial segment our sales were down about $7.5 million versus first and if you take that at our normal gross profit rate in the industrial segment that represents about 1.2 percentage points decline in operating profit. 4X specifically in Asia pack has been the head wind since the first quarter. That represents about .40 of a percentage pointdecline.

And lastly, we had some volume and spending impact through our factories here in the third quarter that we didn't have in the first quarter that reduced our margins about 1 full percentage point. On those on 4x, the Euro is strengthening and I think 4x could be a little bit of a tail wind for us in the fourth quarter. Specifically on the Euro. The spending issue shouldn't repeat in the factory to the extent that it did and hopefully the volumes come back replacing the $7.5 million and the volumes through our factory come up as a result. So none of what we are talking about is a permanent change in the operating profitability of that segment. They are volume related and currency related.

Jim Giannakouros - *Oppenheimer & Company - Analyst*

That's very helpful. Thank you. And one follow-up, if I may. You have mentioned, or were waiting, or anticipating a migration to higher margin equipment in contractor. Can you put some numbers to how high a margin we are talking about versus segment average for that type of equipment? And I believe you sized it in the $80 million or so in sales versus previous peak that is waiting to happen when we get further into the housing cycle?

Jim Graner - *Graco, Inc. - CFO*

As we introduced more products and as we introduce more products on the lower price point in that segment we are going to have a little distraction from where we were historically. If we talk specifically to the $80 million and the higher end proportion of those units we should see if everything else goes flat eventually at 200 or 300 basis point improvement in the segment margins. If we continue to get nice volumes of the lower end units through both the paint and Home Center channel, we may not get there at the level you see it. It will be there, but it will be masked by these profits on these lower priced units.

Jim Giannakouros - *Oppenheimer & Company - Analyst*

Understood. Thank you.

Operator

Our next question comes from the line of Walt Lipticks, with Global Hunter Securities. Please, go ahead.

Walt Lipticks - *Global Hunter Securities - Analyst*

Thanks, good morning, everybody.

Jim Graner - *Graco, Inc. - CFO*

Hi, Walt.

Walt Lipticks - *Global Hunter Securities - Analyst*

Most of my questions have been answered already, but I wanted to just ask on the 2014 number on incremental margin. You pointed out early on in the commentary the very nice 50% incremental margins and I wonder if you can provide some color generally about what is happening at the factories in terms of that? Is it sustainable and maybe the profitability of the powder business and how whatever cost out programs or improvement you are doing are going?

Jim Graner - *Graco, Inc. - CFO*

We have been guiding for a few quarters here that on the long-term you should be looking at a 35% to 45% incremental margin depending upon whether the growth comes in the industrial or the other two segments. We still feel that's the right range. Of course for all of our product lines we are looking at improving costs. We have price increases planned for 2014. Our factory plans are lining up again for zero cost change and powder we have some initiatives that may give us a better performance on that. Overall we feel solid about our business model. We feel solid about our incremental margins. But as you see on our industrial segment when you lose $8 million in revenue a quarter it cuts it the other way as well. We are pleased with the 50% we got this quarter and we guide you a little lower if you are looking at 2014.

THOMSON REUTERS

Walt Lipticks - *Global Hunter Securities - Analyst*

Got it. Wanted to ask too, and see if this works in terms of a question, but industrial CapEx has been constrained this year. There are a lot of sectors that have been down. But with things starting to pick up, the ISM industrial production, do you ever see CapEx budgets coming through in the fourth quarter especially in the industrial side that might provide for a lift in revenue in the fourth?

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

There are certain customers out there that do have a history of fourth quarter CapEx coming through. From what I am picking up from most of my team, I don't anticipate anything big in the fourth quarter like all of a sudden the 2013 pent up demand is just going to bust loose in the fourth quarter. I am anticipating that up tick in capital in fourth quarter, should we see one, will be more in line with what you might expect to see in any normal year and not released of pent up demand. I just don't see the pent up demand at this point for CAP spending.

Walt Lipticks - *Global Hunter Securities - Analyst*

Great, thank you.

Operator

If there are no further questions, I will now turn the conference over to Mr. Pat McHale. Please go ahead, sir.

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

All right, well thank you for joining us this morning. Have a good day.

Operator

This concludes our conference for today. Thank you for all of your participation and have a nice day. All parties can now disconnect.