Company: GRACO INC

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Moderator: Pat McHale

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Operator: Good morning and welcome to the 2nd Quarter 2017 conference call for Graco Inc. If you wish to access the replay for this call you may do so by dialing 1-888-203-1112 within the United States or Canada. The dial-in number for international callers is 719-457-0820. The conference ID is 8781897. The replay will be available through July 31, 2017. Graco has additional information available in a PowerPoint slide presentation which is available as part of the Webcast player. At the request of the company we will open the conference up for questions and answers after the opening remarks from management.

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 2016 annual report on Form 10K and in Item 1A of the company's most recent quarterly report on Form 10Q. These reports are available on the company's Web site at www.graco.com and SEC's Web site at www.sec.gov.

Forward-looking statements reflect management's current views and speak only as of the time they are made. This company undertakes no obligation to update these statements in light of new information or future events. As a reminder today's call is being recorded. I will now turn the conference over to Caroline Chambers, Vice President Corporate Controller in Information Systems.

Caroline Chambers: Good morning everyone. I'm here this morning with Pat McHale and Christian Rothe. Our conference call slides are on our Web site and provide additional information on our quarter. Regal sales for the quarter told of $379 million an increase of 9% from the second quarter of last year and net earnings totaled $80 million. Diluted earnings per share were $1:38 which included 23 cents for the second quarter related to the adoption of a new accounting standard in 2017 that changed the accounting for tax benefits on stock compensation. Year to date net earnings include 28 cents related to this accounting change. The excess tax benefit is recorded when stock options are exercised and the volume of exercises varies from quarter to quarter.

Many of the options exercised this quarter related to grants from 2008 and 2009 which have a low strike price and are nearing expiration. The new accounting standard does not change in any way the amount of cash tax actually paid. It only changes the presentation of this benefit that was previously recorded directly in equity to the income statement. Additional notes on this accounting change are included on Page 6 of our slide deck.

Diluted earnings per share also included 1 cent for the quarter from reduced intangible amortization expense resulting from the apparent charge recorded in the fourth quarter of 2016. Year to date the reduction in the intangible amortization expense affecting diluted net earnings is 2 cents. Foreign currency translation was slightly unfavorable this quarter as compared to last year reducing sales by $4 million and that earnings by approximately $1-1/2 million. Our second quarter gross margin rate improved slightly compared to this quarter last year with strong factory performance and realized pricing offsetting unfavorable FX, currency translation and product mix. Sequentially the margin rate this quarter was slightly less than the first quarter of 2017 due to changes in product mix.

While we anticipated modest increases in commodity prices in the second half of this year we also expect cost reduction activities to offset these increases. Operating expenses were slightly lower than last year for the quarter primarily due to lower amortization expense. The strong sales volume and expense leverage resulted in operating earnings growth this quarter of $21 million or 26% compared to the prior year. A reconciliation of our operating earnings is included on Page 7 of our slide deck.

The tax rate for the quarter was 17% including the benefits and the adoption of the new accounting standard related to stock compensation with the effect of the excess tax benefits reducing the tax provision by $14 million and reducing the effective tax rate by 14 percentage points. Excluding any affect from the change in accounting for stock compensation which will vary from quarter to quarter the effective tax rate for the third quarter and the full year is expected to be approximately 30% to 31%.

Year to date cash flows from operations total $136 million and changes in working capital are in line with volume growth. Share repurchases in 2017 totaled $90 million partially offset by $36 million net proceeds front shares issued. We may or may not decide to make further share repurchases and will evaluate a variety of factors before making that decision. I'll turn the call over to Pat now for further segment and regional discussion.

Pat McHale: Thank you Caroline and good morning everyone. All of my comments this morning are on organic constant currency basis. It was a strong second quarter with growth in every segment in every region of the world and good performance in both developed and emerging economies. In many ways the second quarter performance felt like the first quarter again beating our own expectations with broad based demand geographically and across product categories.

I'll focus my comments on a few of the areas that I think are notable. Contractor America sales were up low single digit in the second quarter which was expected and reflect a difficult comp from the prior year when we had a large home center load in and product launches that have been pushed out from the first quarter. Out the door sales were solid in the quarter for both home center and paint store channels.

Our (Amaya) contractor business posted another double-digit growth quarter, their fourth in a row. Looking ahead their accounts do get very difficult in the second half. The industrial segment posted its best quarterly growth rate since 2014 with the Asia-Pacific industrial business posting a ninth consecutive quarter of growth. We're continuing to see good project activity and have upgraded our regional view.

In America's industrial we remain somewhat cautious. Distributor and end user confidence is higher than a year ago but we haven't seen that result in markedly better selling conditions in most of our end markets. Our oil and natural gas operations were down in the second quarter year over year and sequentially. Notably it's less than 5% of our business. And while we have higher expectations for the second half at current oil prices the picture is cloudy. You'll note our conference call slides we mentioned that we are evaluating certain brick and mortar projects for as early as 2018 driven primarily by our continued growth.

Moving on to profitability, incremental margins were outstanding in the second quarter. The higher revenue growth is driving strong efficiencies in our factories and our expenses are levering nicely. We don't expect this level of incremental profitability to be sustainable but we do expect that over the cycle we will drive incremental margins in the high 30s to the low 40s.

Moving on to our outlook, incoming order rates were strong every month of the quarter in every region. Orders through the first three weeks of July continue to be solid. Mindful of a tough Q4 comp we'd like to see good topline performance continue through Q3. Based on the solid performance in the first half we're raising our full year 2017 outlook from mid-single digits to mid to high single digits. We have a very difficult comp in the fourth quarter resulting in our expectation for a full year growth rate that is somewhat lower than our first half performance. As always we continue to press forward with our long term growth initiatives and hope that our outlook for 2017 will prove to be too conservative. Operator, we're ready for questions.

Operator: Thank you. The question and answer session will begin at this time, to signal please press Star 1 on your touch-tone telephone. And your question will be taken in the order that it – I'm sorry, that it is received. Please stand by for your first question. And our first question today comes from Jeff Hammond of KeyBanc Capital Markets. Please state your question.

Jeff Hammond: Hi, good morning guys.

Pat McHale: Good morning.

Jeff Hammond: Hey so just back on incremental margins, good color there Pat. So as we look into the second half do we start to get back into that mid to high 30s range or is there still a period where we can, you know, kind of run ahead like we have the first half?

Pat McHale: So it really depends I think a lot on volume assumptions. If our volume remains strong I expect our factory performance to be good. I think we're fine on price cost. And I'd expect that these higher levels of volume that you'll see higher levels of flow through profitability than the kind of high 30s to low 40s that would be I'd say normal over the cycle.

Jeff Hammond: Okay. And then just on just a couple end markets I think you cited heavy machinery and ag as, you know, as still challenged. And we're hearing, you know, a lot better things of those markets so can you just talk prospectively how you think those markets shape up?

Pat McHale: Yes. Generally what we're seeing is businesses that have an association with construction have been pretty darn good. But here particularly in the America's industrial some of the businesses that are not associated with construction, you know, we hear optimism and we're hearing better things from our distributors and end users. But from our standpoint really haven't seen that result in a lot of push through. So maybe it's coming. We hope it is but from our standpoint we're really not seeing it outside of construction right now.

Jeff Hammond: Okay, thanks a lot guys.

Operator: We'll go next to Saree Boroditsky of Deutsche Bank.

Saree Boroditsky: Hey, good morning.

Pat McHale: Good morning.

Saree Boroditsky: So industrial APAC has been strong for the last couple of quarters but you just upgraded the current outlook. So you – could you talk about what you're seeing in that market and if there was anything that changed in the quarter that made you more confidence outside of the strong results?

Pat McHale: Yes, I think it's just breath of results across region and across product categories. We've seen some consistency now for a couple of quarters and that's – that read there has given us some good feeling about what's going to happen going forward.

Saree Boroditsky: Okay, that's helpful. And then just staying on industrial, you know, another strong quarter of margins and it looked like it was largely volume related but product and channel mix were also highlighted in the slide. So could you provide more color on any mix, or product or region that, you know, helped with the margins?

Christian Rothe: Yes Saree, this is Christian. So don't necessarily want to get into that level of detail but yes we did have some - the overall good health from the volume side in particular. And as Pat said price cost is favorable as well. So the expense leverage that we got off of that had really good flow through profitability.

Saree Boroditsky: Okay great. Well thanks for taking my question and congratulations on another strong quarter.

Operator: And we'll go next to Mike Halloran of Robert W Baird.

Mike Halloran: Hey, good morning everyone.

Pat McHale: Hi Mike.

Mike Halloran: So could you guys just talk a little about sustainability here Pat? It sounds like core trends across your businesses are progressing ahead of expectations as you get to the back half of the year and just kind of ignoring year over year comparisons and just thinking about terms of – in terms of sequentials anything out there right now that's derailing the momentum, any concern points you have across those segments?

Pat McHale: Yes I'd say nothing really stands out. You know, I don't have a crystal ball and can't predict what's going to happen in the future markets but from what I'm seeing right now today's things look to be in a good position and, you know, the organizations performing very nicely from our sales teams all the way through to our factory. So, you know, given that we stay the rails I don't see any reason that things are going to change markedly going forward.

Mike Halloran: Makes sense. And then the CAPEX projects you alluded to was that specifically for the process segment or was that a broader comment across your businesses?

Pat McHale: Yes, that's of broader comment across our businesses. We've got a few locations with strong growth we've been pointing out that are becoming squeezed. And so we'll probably be looking at doing something starting next year.

Mike Halloran: And then any – that makes a lot of sense. And that any changes to your thoughts on what to do with your strong free cash flow at this point?

Pat McHale: Yes, we have those debates and we'll figure it out. You know, right now we don't have a pile of cash that we have to deal with. Obviously that's going to change as we get into the second half unless we find some opportunities. But we prefer to be opportunistic at this point and not make a decision right now today and we don’t have to.

Mike Halloran: Sounds good, appreciate it, take care.

Pat McHale: Yes.

Operator: Our next question comes from Matt Summerville of Alembic Global Advisors.

Matt Summerville: Thanks, a couple questions, just first on process. Can you talk more – in more granular detail about what end markets are driving the double-digit volume gains you’ve seen year to date? While oil and gas is sort of small as a percent of total Graco obviously as a percent of the process business it’s a bit more consequential. And then after you discuss end markets maybe talk about at this kind of volume run rate, you know, net of mix fluctuation what do you think is the right bandwidth of margin profile for this business?

Pat McHale: So I’ll take the first piece and I’ll let Christian take the second piece. You know, within that process category we’ve got our – what was our old lube business which has got both vehicles services and industrial lube. We’ve got some semiconductor exposure in there. We’ve got our sanitary exposure there. We’ve got our well car standard process business for chemicals and pharmaceuticals. So we’ve got a variety of end markets in there. And I’d say generally business has been pretty good outside of oil and gas. The margin question I’ll let Christian take a stab at that.

Christian Rothe: Yes Matt, this is Christian. So with regard to the margin looking at the volumes that we’ve had so far this year it’s been pretty good. If those kind of volumes hold in, you know, we’ve been in the high teens on operating margins. That’s the ballpark that we’re in. In order to get into the 20s we’re going to need more volume.

Matt Summerville: And then just one last one. In terms of the contractor business Pat, you know, how far through sort of in the cycle do you think we are in terms of sort of a re-saturation of product into the end user base? I guess what we’re trying to get a sense of is how much further does this contractor story have to play out particularly in the America's now coming up against not just one quarter or two accounts but, you know, a couple of years of very nice growth there?

Pat McHale: Yes, I mean that's a good question. I don't think anybody has the answer but I, you know, I'll remind you that our contractor business really came out of the downturn back in 2010. That's a long time ago. So I don't think what's happening in the market today is reflective of some pent-up demand going back 2007, 2008. I think we've seen continued improvement in the housing market coming out of the downturn. You know, we've always been of a mind that we ought to be doing at least a million and a half on housing starts. And we're headed back there. We think that that's a nice healthy sort of end market for us to be able to sell our equipment.

That division historically has done a great job with new products. And I think the last couple years' is no different. So, you know, I think end market dynamics are good. We expect the end market dynamics to continue to stay solid going forward. You know, how long till the next downturn who knows? But right now we don't see it and we think that, that business is going to continue to perform.

Matt Summerville: Thanks Pat. Thanks Christian.

Operator: Our next question comes from Charlie Brady of SunTrust Robinson Humphrey.

(Patrick Rule): Hi. Good morning Pat, Christian and Caroline, thanks for taking my question. This is actually (Patrick Rule) standing in here for Charlie.

Pat McHale: Good morning Charlie.

Christian Rothe: This is (Patrick).

Caroline Chambers: (Patrick)

Pat McHale: Sitting in for Charlie. I knew that, sorry.

(Patrick Rule): No problem, no problem. Just a couple of questions on end markets, I guess the first questions on end market. In process you call project activity as spotty. Where are you seeing the positive and negative areas? Has pricing getting better on these projects businesses? And then how much pent-up demand are you seeing in mining? This used to be pretty widespread positive commentary that a market is finally seeing a bottom and picking up a little – picking up off a low base? Just any color on that will be great. I've got ((inaudible)) question.

Pat McHale: Sure. In terms of product activity, you know, productivity it's blips here and there. And can move our results quarter to quarter and that's why we call it spotty. I mean these aren't ongoing projects that we get from the same customer at the same time. But generally the volume of products in the pipeline has been pretty healthy here the last couple of quarters.

In terms of mining specifically we are seeing improvements in sales into our distribution channel that serves the mining market. We think that that's positive. And, you know, commodity price increases I think we might've talked about this on first quarter call but I view rising commodity environment as good for Graco. I view that ultimately we're going to do better in markets where we have rising commodity prices because we've got a great manufacturing footprint. We've got a strong gross margin. So we're generally able to minimize the negative impacts of rising commodity prices. But rising commodity prices drive a lot of capital investment in markets like mining, and oil and gas that give us great opportunity. So, you know, all in all I think that that's a good story for us at the moment.

(Patrick Rule): Great, that's good color. And then just the – did you see a little bit of a step down in terms of selling, marketing and distribution expenses in the second quarter? Is that something that we should expect moving forward or just something that was sort of a change in the dynamic for just this quarter alone? Any color and that would be great.

Pat McHale: Yes, I don't think we haven't really had any change of philosophy. You know, we've invested a lot in our growth initiatives over the last few years and we're continuing to invest in those. You know, we have had good expense management but, you know, also if you look at the last couple years we've had some spending in some areas to do consolidations on acquisitions and other activities that have increased our spending. And now we're starting to see some results there. So, you know overall I feel like generally speaking we're fully funding our future growth and that the current level of SG&A is adequate. And if we get ideas we'll fund them but I view going into the second half this shouldn't be a dramatic change.

(Patrick Rule): Great, nice solid quarter. Thanks guys.

Operator: We'll take our next question from Dean Dray of RBC Capital Markets. Please check your mute button or pick up your handset. We can't hear you at this time.

(Jeff): Hi. This is (Jeff) on for Dean Dray. My first question is you had two consecutive quarters of double-digit growth. Is there any way you can parse out what's end market growth and what would be market share gain?

Pat McHale: No, that's really impossible for us to do. You know, we have really broad product categories that we sell through distribution channel and then they sell them to customers. And so our products can be used in lots of different end markets and applications. And there's nobody out there that is able to track, and aggregate and report market shares on most of our product categories. So I'm sure that's what's going on is a combination of good end markets, and good new product performance, and good performance by our channel but I can't break it out for you.

(Jeff): Got you. And then are you seeing any pricing pressures from e-commerce and maybe how might Amazon become a disruptor in any of your markets like contractor?

Pat McHale: Yes, no we're not seeing that at present. I'm not overly concerned about it. We are as an organization of course keeping our eye and everything that's happening out there in terms of channel and technology but, you know, the strong majority of our products do require a lot of support. They get built into systems or applications. And I just don't feel like – I think that we can use what's going to happen with technology to our advantage versus have it crush us like we've seen in some other industries.

(Jeff): Got you. Thank you.

Operator: And as a reminder it is Star 1 if you'd like to ask a question at this time, again Star 1. We'll take our next question from Walter Liptak of Seaport global.

Walter Liptak: Hi, thank you. Good morning guys.

Pat McHale: Good morning.

Walter Liptak: Wanted to ask you a question about the price cost. And you may have alluded to this earlier but I missed it but generally how, you know, generally how much would you say is price that you got during the quarter versus volume?

Caroline Chambers: Obviously our factories were running very strongly this quarter and we saw nice performance out of all of them. I think our realized pricing was in line with what we generally are seeing, maybe a little on bit on the lighter end this quarter.

Walter Liptak: Okay. Did prices go up in - at the beginning of the year or, you know, with some of our companies we're seeing prices going up in the second quarter because of material cost headwinds, you know, when was your last price increase?

Pat McHale: Yes, we generally run our price increases consistently at the beginning of the year and we don't do major price increases. Again, you know I've been here a long time and I don't remember a commodity environment that created an overly dramatic amount of pain for us where we would consider anything like a midyear price increase. If you just do the math and you take a look at our overall gross margin well than 45% is going to be cost of goods sold. And of that there's going to be labor and overhead in there.

And then things that we buy contain materials but they also contain labor. So when you really take a look at the impact to Graco of commodity price inflation, you know, it can be a few million bucks but we've easily got a few million bucks of cross productions going on in our factories. And I don't really lose too much sleep over the price costing. I think we are well-positioned as an organization to be able to handle that. And again I really do like a rise in commodity price environment. And I think it really helps our commercial teams and in the end we make more money.

Walter Liptak: Okay. Yes that's the greatest position to be in. You know, a follow-on to, you know, the Asia questions I wonder if you can talk about the margins on some of those projects and process, or some of the margins kind of into Asia generally? I don't think you guys break that out typically but does Asia tend to be, you know, where does that tend to fall in terms of kind of the range of profitability by geographic region?

Pat McHale: Yes, we don't break that out. I would just tell you that if you take a look at similar sorts of products and end markets our margins aren't dramatically different around the world. So we don't have huge disparities in terms of pricing our margins regardless of where we go.

Walter Liptak: Okay great. All right thank you.

Operator: We'll take our next question from Jim Giannakouros of Oppenheimer & Co.

Jim Giannakouros: Good morning everyone.

Pat McHale: Good morning.

Caroline Chambers: Good morning.

Jim Giannakouros: What areas were the sources of surprise versus your expectations? And I know end market discussion just given that your sell through distribution is tough but assuming that you have line of sight internally can you speak to the product categories that are knocking it out of the park for you?

Pat McHale: Yes, I when the say there was anyone thing that was a surprise. I'll say from my standpoint and if you go back to where we were at, at the end of the first quarter it's hard just based upon the environment to take a view that you're going to go up in all product categories and all geographies. And I would say that's the most pleasant surprise. It's not any one particular product line that is surprising me.

Jim Giannakouros: Okay. And I guess implications for the second half does your updated guidance imply higher second half sales then you had contemplated just a couple months ago or should we take your guidance adjustments strictly as tied to first half outperformance?

Pat McHale: Yes, I think probably maybe more the latter but, you know, we tend to be conservative. We take some flak for that. It's – we just go to work every day and do our job and try to see how it comes out in the end.

Jim Giannakouros: Fair enough. Last question if I may in contractor – I apologize if you did touch on this but mix influences to margins so far this year and outlook there appreciating that, you know, the, you know, the handhelds has been a, you know, a growth driver for you and that's been negative mix but I wonder if as we get further along in the cycle that you're maybe upselling and having more highly engineered (proportioners), et cetera, being sold that's influencing mix there?

Pat McHale: Yes, you know, I think that's pretty hard to predict. If you're looking to say in the coming quarter or coming half what's going to happen with mix. I mean we're always interested in what orders we got last week. We're pretty much a book and ship for a large percentage of our business and trying to predict what's going to happen with mix is pretty difficult.

Jim Giannakouros: Fair enough. Thank you.

Operator: And again as a reminder that's Star 1 for any other questions, Star 1. And we'll go next to Liam Burke of FBR Capital Markets.

Liam Burke: Yes thank you. Good morning. Pat you mentioned you were happy with the performance of the new products and they were contributing to the growth for the quarter. How has the pipeline been and do you expect that to continue through the rest of the year?

Pat McHale: Yes, you know it's pretty regular. We don't have a big centralized engineering group. Each one of our business units has its own product development which means that we've got product development activities and new product launches happening pretty regularly in our business units on a regular basis. So I would say the pipeline looks fine. It has looked again I'd say pretty consistent the last few years. We did a big ramp up in spending you may recall in '07, '08, '09 where we added engineering teams. So I think all the business units are pretty well-funded and are doing a pretty decent job.

Liam Burke: Okay. And on the competitive front is it pretty much the same or are you seeing anybody crop up particularly in any particular geographic region?

Pat McHale: No, you know, there's regional players that pop up from time to time but, you know I've been here 27 years and all the big competitors are for the most part the same ones we had 27 years ago. They're good strong competitors and they give us challenges around the world. But, you know, usually the regional players have trouble having the geographic reach and I haven’t seen anything significantly new on that front.

Liam Burke: Great, thank you Pat.

Pat McHale: Yes.

Operator: And with no further questions I will now turn the conference back over to Pat McHale.

Pat McHale: All right well I thank everyone for their time this morning and we’re going to get back to work. We’ll talk to you at the end of the third quarter.

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