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GGG.N - Q1 2022 Graco Inc Earnings Call

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OVERVIEW:

Co. reported 1Q22 sales of \$494m, reported net earnings of \$101m and reported diluted EPS of \$0.58. Expects 2022 revenue to be in high single-digits on organic constant-currency basis.

CORPORATE PARTICIPANTS

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PRESENTATION

Operator

Good morning and welcome to the first quarter conference call for Graco Inc.

If you wish to access the replay for this call, you may do so by dialing 1 (855) 859-2056 within United States or Canada. The dial-in number for international callers is (404) 537-3406. The conference ID number is 2464642. The replay will be available through 2:00 p.m. Eastern time, Thursday, May 5, 2022.

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 purpose 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 2021 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 management's current views and speak only 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 Kathy Schoenrock, Executive Vice President, Corporate Controller and Information Systems.

Kathryn L. Schoenrock - *Graco Inc. - Executive VP, Corporate Controller & Information Systems*

Thank you. And good morning, everyone. I'm here today with Mark Sheahan and David Lowe. I will provide a brief overview of our quarterly results before turning the call over to Mark for additional discussion.

Our conference call slides have been posted on our website and provide additional information that you may find helpful. Beginning this quarter, our high-performance coatings and foam product offerings historically included within the Industrial segment were realigned and are now managed and reported under the Contractor segment. The change will allow business leadership to address the overlap in markets, products, end users and

distributors for all of our contractor-focused businesses. Prior year segment information has been restated to conform to the current organizational structure, and we have provided restated historical results by quarter on our website.

Yesterday, Graco reported first quarter sales of \$494 million, an increase of 9% from the first quarter of last year. The effect of currency translation rates decreased sales by 2 percentage points or approximately \$7 million in the first quarter. Reported net earnings were \$101 million for the quarter or \$0.58 per diluted share. After adjusting for the impact of excess tax benefits from stock option exercises, net earnings were \$99 million or \$0.57 per diluted share.

The gross margin rate was 60 basis points higher than the fourth quarter of last year but is down 300 basis points from quarter-over-quarter. The decline from the first quarter of last year was primarily from higher input costs and the adverse impacts of changes in currency translation rates. Our 2022 pricing actions are taking hold, and we expect to realize the full impact of our price increases as we move through the second quarter and sell-through the remaining 2021 backlog. At current costs and volumes, we expect that our 2022 pricing actions will offset these input cost pressures on a dollar basis and result in a modest gross margin rate improvement in the second half. Of course, costs of many commodities remain volatile and will be closely monitored.

Total operating expenses increased \$7 million in the quarter, which includes a \$3 million charge for the full exposure of our receivables in Russia and Belarus. This amount is included in unallocated corporate expense. We have currently suspended our sales in Russia and Belarus. While we do not have any physical operations in the country, we do have a handful of employees. Sales to Russia and Belarus in 2021 were approximately 1.5% of total consolidated sales.

Interest expense increased by \$3 million in the quarter. This increase relates to a \$3.5 million fee associated with the prepayment of \$75 million of our private placement debt. The adjusted effective tax rate was 19% for the quarter, which is comparable to the first quarter of last year.

Cash flows from operations totaled \$31 million, a decrease of \$70 million from last year, mostly driven by an increase in annual incentive payments and inventory purchases to meet demand levels.

During the first quarter, we repurchased 1.5 million shares for \$109 million, which will largely offset our dilution in 2022. As I mentioned earlier, we prepaid \$75 million of our private placement debt. We also made capital expenditures of \$47 million and had dividend payments of \$36 million.

Finally, our full year estimates for currency impacts, unallocated corporate expense, tax rate and capital expenditures can be found in the conference call slide deck, on Page 11.

I'll turn the call over to Mark now for further segment and regional discussion.

Mark W. Sheahan - Graco Inc. - President, CEO & Director

Thank you, Kathy. And good morning, everyone. All of my comments this morning will be on an organic constant currency basis.

We started the year strong with record quarterly sales in all reportable segments. The Industrial and Process segments experienced broad-based sales growth in all regions. In Contractor, North America and Asia Pacific remained positive, but EMEA saw a decline in the quarter driven primarily by limited product availability due to component shortages for large paint sprayers. Incoming order volume remains elevated and outpaces our ability to deliver.

Long lead times in key materials and components such as electronics, castings, engines and motors resulted in a 19% increase in our backlog from the end of last year. Our consolidated backlog was approximately \$445 million at the end of the first quarter, which is \$70 million higher than what it was at the end of last year.

We have implemented our annual price increase. However, as expected, due to the size of our year-end backlog, which is at last year's pricing, we did not realize its full impact during the quarter. A majority of last year's backlog has now been shipped. Therefore, we should see a greater impact

from pricing on profitability for the remainder of the year. At current costs, we believe that our pricing actions will be enough to offset cost pressures from inflation on a dollar basis.

Now turning to some commentary on our segments. After a very strong first quarter last year, the Contractor segment was up low single digits in the quarter. We were heavily impacted by component shortages for our large paint sprayers, which primarily serves our North America and EMEA customers. Our inability to ship these larger, more profitable units negatively impacted operating earnings during the quarter.

Our incoming order rates have continued to grow in all product lines, resulting in a backlog of over \$100 million, which is up 20% since the end of last year. While mortgage interest rates have increased recently, contractors remain busy. Housing starts are still projected to be 1.7 million units this year. New and existing home sales remain strong. Commercial construction is forecasted to be up mid-single digits. And remodeling is forecasted to increase double digits during the year.

We believe that our 2022 pricing actions largely implemented in the quarter, along with improved product mix, should positively impact profitability in Contractor for the remainder of the year.

The Industrial segment posted its fifth consecutive quarter of double-digit growth. The segment grew mid-teens and achieved first quarter records for sales and operating earnings, resulting in impressive incremental margins of 64%. Sales remained strong in all major geographies, with solid demand in many product categories such as liquid finishing, powder coating and sealant and adhesive equipment. We are still facing component and logistical constraints, which have contributed to an increase in backlog of \$24 million compared to the end of last year and \$75 million compared to the same time last year.

The Process segment grew 26% for the quarter, resulting in records for both revenue and operating earnings. We saw continued strength in demand for worldwide lubrication equipment, process pumps and semiconductor products. Incremental margins were negatively impacted by cost pressures on key components. Backlog is elevated, and we're optimistic that the pace of business will persist throughout 2022.

Moving on to our outlook. Underlying demand in our key end markets and geographies remains healthy. However, we are keeping a close eye on how economic and geopolitical conditions may impact the balance of the year. For now we are confirming our 2022 revenue guidance of high single digits on an organic constant currency basis, with growth expected in every reportable segment. While operational challenges persist, we intend to fully execute against our core strategies.

We are investing in new product development initiatives. We continue to make investments in our facilities and distribution channel. We are focused on finding profitable growth opportunities in attractive niche markets through a combination of both organic initiatives and a new focus on external activities, including acquisitions. I'm proud of the hard work that our teams are doing in some challenging times. It's fantastic to see everyone stepping up to help in classic Graco fashion.

That concludes our prepared remarks. Michelle, we're ready for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Deane Dray with RBC Capital Markets.

Deane Michael Dray - *RBC Capital Markets, Research Division - MD of Multi-Industry & Electrical Equipment & Analyst*

You guys usually provide a monthly cadence of organic sales and a forward look on, in this case, April. Do you have those specifics here?

Mark W. Sheahan - Graco Inc. - President, CEO & Director

We didn't disclose that this quarter, Deane. It's a monthly look, and sometimes that can be a bit misleading. I'll tell you that orders are still coming in. Backlogs are up. And at least so far here in the first quarter, we are ahead of like where we were at the -- last year, at this time.

David M. Lowe - Graco Inc. - CFO & Treasurer

What I would add is that we introduced that chart, I think, about 2 years ago when we stopped doing guidance. And we thought, during 2020, it gave a bit more visibility in extremely uncertain times. And we thought it was relevant to continue it in '21 because of the sharp changes in business demand.

Deane Michael Dray - RBC Capital Markets, Research Division - MD of Multi-Industry & Electrical Equipment & Analyst

Got it. I would make the case that we're still in a very uncertain stage of visibility, but I appreciate the color and context. And just to clarify, on the Russia write-down, you said that was all of your receivables. And you did include that in operating results, which from a quality-of-earnings standpoint, we really appreciate. Most of your peers are using that as a onetimer. But just to clarify that's it on the Russia exposure.

Mark W. Sheahan - Graco Inc. - President, CEO & Director

Yes, that is it.

Deane Michael Dray - RBC Capital Markets, Research Division - MD of Multi-Industry & Electrical Equipment & Analyst

Okay. And then just lastly, what's the -- can you calibrate for us how much you could not ship this quarter? I know it's short cycle for you. You're not typically building a big backlog, but can you calibrate for us either past due, was not able to ship because of component pieces and so forth?

David M. Lowe - Graco Inc. - CFO & Treasurer

Well, this is David Lowe. I'll take a shot at it and then someone else may want to elaborate. I've been puzzling with that one myself. Here is how I am thinking of it, Deane. Is that, if you look at -- maybe the last "normal quarter" with respect to supply chain was the first quarter last year. And Q1 is because of the seasonality of CED, is pretty volatile. Or it's pretty -- it's front-end loaded.

So in '21, our backlog across all of our businesses grew about \$50 million. And I would say that maybe that was certainly more normal than what we've seen since the end of the first quarter with respect to our ability to ship. This quarter, as Mark mentioned, the number is \$70 million. I would basically make the case that certainly the supply chain challenges are contributing to some portion of that increase. Maybe it's \$15 million or \$20 million. And we'll never know precisely, but that seems about in the range of possibility when I talk to the several factories on where orders and how orders have been building up.

Deane Michael Dray - RBC Capital Markets, Research Division - MD of Multi-Industry & Electrical Equipment & Analyst

That's helpful. Just last one, on the price increase. And look, we're used to this is -- the playbook for Graco is to put the price through annually in January, and it takes a bit for that price realization to read across. Just give us some context. What was the price increase like this year? Any receptivity, any pushback? And your expectations from here.

Mark W. Sheahan - Graco Inc. - President, CEO & Director

Yes, without getting into like real specifics because it does vary based on the businesses and the geographies that we participate in. It was significantly higher than what I'll call a normal price increase would be for Graco. And it has been fully implemented. We're starting to see really good realization. And there are obviously some customers that push back, but I would say, generally speaking, no one was surprised by what we did and the pricing increases and the actions that we've had have been received kind of in line with what we had expected.

Deane Michael Dray - RBC Capital Markets, Research Division - MD of Multi-Industry & Electrical Equipment & Analyst

That's all really helpful.

Operator

And our next question comes from the line of Mike Halloran with Baird.

Michael Patrick Halloran - Robert W. Baird & Co. Incorporated, Research Division - Associate Director of Research & Senior Research Analyst

So first, just high level here. Obviously, in the outlook, you mentioned that you're keeping an eye out for where some of these challenges in -- from the macro or geopolitical perspective could impact you, but other than the component shortages that you highlighted, particularly on the larger products in the Contractor, is there anything you're seeing right now that concerns you? Or are there any cracks that you're seeing in the order patterns, or with any of the -- in the product lines, geographies, et cetera? Anything you'd point out specifically?

Mark W. Sheahan - Graco Inc. - President, CEO & Director

I think just what we've said. I mean we're definitely keeping an eye on the things that we really can't control, like what's going on in Europe and the war and whether that results in any kind of a slowdown there. Obviously, our numbers, we haven't really seen a whole lot of that happening in our Industrial businesses. And what we saw in Q1 on CED was really probably more self-inflicted on our part and just not being able to get the right products over there due to the component shortages that we had.

So that's one area that we're keeping a close eye on, and the second one is China. They've got COVID lockdowns happening in different cities throughout the country. And that's something that, hopefully, will disappear at some point. And usually what happens there is, when it does disappear, it comes back pretty quickly, but those are probably the 2 things that I would point out to you at this point that are worth keeping an eye on.

David M. Lowe - Graco Inc. - CFO & Treasurer

I would agree with Mark. I would add that we're tracking interest rates, of course. We've seen intermediate long rates move up a bit over -- since the beginning of the year. And while there's not so much we can do, but -- on the issue of foreign exchange, so far, that's been a modest headwind for us. And we're tracking that.

Michael Patrick Halloran - Robert W. Baird & Co. Incorporated, Research Division - Associate Director of Research & Senior Research Analyst

Are you -- but are you seeing any of that hit your order book or customer purchasing patterns like currently? I know a lot of those things are things we're keeping an eye on -- okay, so no though, right?

Mark W. Sheahan - Graco Inc. - President, CEO & Director

No, not yet.

Michael Patrick Halloran - Robert W. Baird & Co. Incorporated, Research Division - Associate Director of Research & Senior Research Analyst

Okay, all right, that makes sense. So then on the capital deployment side, maybe just some thoughts. I know you guys have elevated internally how you're thinking about the M&A side of things. Maybe just an update on the funnel and how you're thinking about that? But then also willingness to think about buybacks on a larger scale given the backdrop?

Mark W. Sheahan - Graco Inc. - President, CEO & Director

Yes. I'll let David handle the buyback question, and I'll talk about M&A. I mean, for sure, we've put it on the radar for our teams that we'd like to see a little more activity on external growth as an organization. And we have hired a leader for our corporate development group. He started fairly recently, so we're in early days here, but we do see some nice traction, I guess, within the divisions. At least we're starting to talk about M&A more, and we're looking at creating some pipelines and things like that.

We did do a small deal in the quarter that you probably saw. It was another company that was related to our semiconductor business. They make sort of high-purity fluid-handling valves and cylinders and spray guns and things like that, so it's a nice complementary business for that particular segment. It's small, so it's not like going to move the needle, but I would say that we're hoping to have a little bit more growth out of M&A here over the next 5 years or so during our planning horizon. And we'll see what happens. And I'll let David talk about share buybacks.

David M. Lowe - Graco Inc. - CFO & Treasurer

So I think that, in terms of the financial capacity for the company, the acquisition activity that Mark is talking about, we have good dry powder for that. We also have the dry powder to evaluate the other components of our uses of cash, and that includes stock buybacks. We believe that certainly share creep is something to be avoided. And we took steps in the first quarter to manage what we think is going to be the share creep exposure or approximately so for the current year.

And I think that we will be following the movements in stock price closely as we always do. And in the event there are opportunities based on pricing, I think that we won't be shy about taking steps that we think are consistent with our long-term value approach. As I think you know, we do track our stock purchases on an ROI basis. And when we look back over the last decade, the returns have been very attractive. And there are times in markets when industrial companies trade at a bit of a discount, and we want to be ready if and when that opportunity presents.

Operator

And our next question comes from the line of Matt Summerville with D.A. Davidson.

Matt J. Summerville - D.A. Davidson & Co., Research Division - MD & Senior Analyst

I was wondering if you guys might -- it would be helpful if you're able to somehow parse out a little bit maybe in Q1 how much of the headwind you saw to operating earnings was driven by unabsorbed inflation versus some of the mix challenges you've been referencing throughout, Mark.

Mark W. Sheahan - Graco Inc. - President, CEO & Director

Yes, I'll start. And if Kathy wants to chime in, I'll let her do so, but I think at a high level, like we said in our opening comments, we're really covering the price cost right now with our pricing actions and looking at the costs that came in, in the first quarter. So in particular when you look at the

Contractor business, which is really where you saw the margin rate come down pretty substantially, it was the majority of that decline was really driven by the mix of the products that they sold in the quarter. So that's sort of why we tried to highlight these higher-end sprayers as kind of being a main reason for it. And hopefully, as we work our way through the year, those trends equalize. I don't know if you have anything else to add, Kathy.

Kathryn L. Schoenrock - Graco Inc. - Executive VP, Corporate Controller & Information Systems

Yes, I think that's right. The other thing in there is the currency impacts that we have that are negatively affecting our operating earnings as well.

Mark W. Sheahan - Graco Inc. - President, CEO & Director

Yes. It's a good point.

Matt J. Summerville - D.A. Davidson & Co., Research Division - MD & Senior Analyst

So as a follow-up then with respect to Contractor is that component availability. Has that gotten better for those large sprayers? And then to flip over to Industrial, how should we be thinking about the go-forward margin cadence given the high watermark you set in Q1 despite cost headwinds, despite FX headwind? I mean that was a pretty strong margin performance there.

Mark W. Sheahan - Graco Inc. - President, CEO & Director

Yes. So I think that we're still facing the challenges. Anybody that follows the industry knows that getting electronic components, which is really mostly what we're talking about, the chips and then the motors too, is still challenging for us. So our teams are working really hard. And I have high confidence that we're doing everything that we can, but we haven't seen a meaningful shift, I would say, in terms of our ability to get components in here.

We are shipping those products out, but we'd like to be able to do it at a much higher rate as possible. And then on the Industrial side, I mean, yes, they've had tremendous earnings growth here in the quarter and really good leverage. And I don't see any real reason why, as long as they can continue to put points on the board, on the top line, that the bottom line should really suffer from here.

Operator

And our next question comes from the line of Jeff Hammond with KeyBanc Capital Market.

Jeffrey David Hammond - KeyBanc Capital Markets Inc., Research Division - MD & Equity Research Analyst

Just on these kind of components that are short supply, particularly Contractor, that's delaying kind of shipments on the large sprayers. Are you seeing that get worse? Or what's your line of sight that you'll be able to start to catch up there?

Mark W. Sheahan - Graco Inc. - President, CEO & Director

It hasn't gotten worse, but it hasn't really gotten better either. So I think it's sort of the same as what we were experiencing in Q1. It's kind of what we're seeing right here today.

Jeffrey David Hammond - KeyBanc Capital Markets Inc., Research Division - MD & Equity Research Analyst

Okay. And then just on price. I guess we're seeing, kind of post the war or start, kind of a re-acceleration and a lot of inflation. And I'm just wondering what your confidence is that this kind of Jan 1 price increase captures all that inflation. And if we see more, do you change your tact and put through another price increase, or do you wait again?

Mark W. Sheahan - Graco Inc. - President, CEO & Director

Yes, I'd say right now we're in good shape. And beyond right now, I don't have great visibility into what's going to happen 3, 6 months from now. We do like playing the long game on pricing. I don't really see us moving meaningfully away from that. I never like to say never about anything, but for now I think we're going to stick with our current plan, and hopefully, our pricing actions that we did here in early '22 are enough to help us out throughout the year.

David M. Lowe - Graco Inc. - CFO & Treasurer

Yes. And I would agree with everything that Mark elaborated on. I would add, when we look at the impact of pricing in the first quarter, on our actual business, I've been impressed with the realization that we've seen. We've seen it in all the segments. And when you consider that at the same time we were working through a big chunk of our December '21 backlog, I think that's particularly impressive. So I'm feeling very good at the moment about how pricing is going to contribute to results over the balance of the year.

Jeffrey David Hammond - KeyBanc Capital Markets Inc., Research Division - MD & Equity Research Analyst

Okay, great. And then just last one, on Contractor. If you look in the orders -- because I understand volumes were probably -- unit volumes were probably negative but seems more of a supply than a demand issue, but if we look at Contractor order rates, if you kind of ex out price, are you still seeing growth in unit volumes?

Mark W. Sheahan - Graco Inc. - President, CEO & Director

Yes. I mean orders were solid in the quarter. And you saw the big increase in the backlog, so we haven't really seen any kind of a major change there. It's still pretty good business for some of the things that we talk about, a good market for painters in general.

Operator

(Operator Instructions) And our next question comes from the line of Andrew Buscaglia with Berenberg.

Andrew Edouard Buscaglia - Joh. Berenberg, Gossler & Co. KG, Research Division - Analyst

I was hoping you can give a little bit more color on -- just on the dynamics in Industrial because that's been so strong for quite a while now. And specifically, like, in terms of managing inventory and the pricing dynamics, as it relates to this table that you guys present every year about how 40% of your sales have average number of units sold, 0 to 1 a day, I would think in Industrial that would be a like a very big benefit in this type of environment and lends credibility that there's legs to this industrial cycle. Is that fair to say? And can you just talk a little bit about how that impacts that business?

Mark W. Sheahan - Graco Inc. - President, CEO & Director

Yes. I mean I think the pricing actions that we took in Industrial are being realized, and they're showing up in the incremental margins. And I also feel pretty good about our ability to manage the complexities of which products we actually have to sell given the breadth of our SKUs and, as you indicated, how sales actually play out in that space. So, so far this year, I think they're on very solid footing.

Andrew Edouard Buscaglia - Joh. Berenberg, Gossler & Co. KG, Research Division - Analyst

And is it fair to say for the Process segment as well, like same type of dynamics playing out.

Mark W. Sheahan - Graco Inc. - President, CEO & Director

Yes. It's more or less the same, kind of sell through distribution, industrial end markets, complex product lines, but it's something that we also feel pretty good about right now.

David M. Lowe - Graco Inc. - CFO & Treasurer

Yes. I mean I think that -- I was just going to say yes. The -- I mean it's not that pricing power is unlimited. There is a market, but the industrial and process products generally that go into manufacturing arenas are mission-critical pieces of equipment. And when the end user needs them, he typically needs them now. And the channel, while very competent and capable, is typically not a stocking channel. So it is part of the overall company's value proposition that, yes, as -- we strive and -- to do a good job with the customer service and deliveries. And over the long haul, we think that has justified perhaps the premium you see on many of our products.

Andrew Edouard Buscaglia - Joh. Berenberg, Gossler & Co. KG, Research Division - Analyst

Yes. So for the Industrial, when you see kind of an eye-catching 36.4% operating margin, over 60% incremental margin, that's -- you do think that, that is somewhat sustainable, as long as the volumes are there, right?

Mark W. Sheahan - Graco Inc. - President, CEO & Director

Yes. So volumes are there. I think we feel good about that. I don't see profitability really taking a step back at this point. I think they're in really good shape.

Operator

And our next question comes from the line of Thomas Johnson with Morgan Stanley.

Thomas Claes Johnson - Morgan Stanley, Research Division - Research Associate

Just kind of honing in on the Contractor business and just in terms of how we should think about the kind of deferred demand from that component shortages in the EMEA region. I guess, firstly, is it safe to assume that, if that supply -- if those supply chain issues had been remedied, that sales there would have at least been flat on a year-over-year basis? And then just kind of adding color to that, were those component shortages worse than you had initially anticipated kind of exiting fourth quarter of last year?

Mark W. Sheahan - Graco Inc. - President, CEO & Director

Yes, it's hard to know exactly what would have happened, but for sure, we would have shipped a lot more product out the door because we've got large backlog in Contractor. It's over \$100 million. And our team there is doing everything they can to get as much product out the door as they can every single day while chasing a lot of these component shortages. In terms of whether things have gotten different from the end of the fourth quarter, I would probably say not really. I mean I think that, even at the end of last year, we were faced with a lot of these challenges. And when we started -- knew, going into the year that this could be an ongoing situation. It's pretty much prevalent across most of industrial America today that getting various components is a big challenge.

So I know -- what I know is what we are doing here at Graco. And we're doing everything we can to source. And in some cases, we're actually redesigning some of the products. We've got our engineering teams looking at alternative ways to manufacture the products to get more products out the door, so very confident that we're doing all hands on deck and everyone is working hard on those issues.

Thomas Claes Johnson - Morgan Stanley, Research Division - Research Associate

Great. And then last one on that, the kind of outlook for the rest of the year for that segment. Are you guys assuming that those component shortages start to ease or just kind of remain as is in your base case outlook?

Mark W. Sheahan - Graco Inc. - President, CEO & Director

Yes. I think we think they're going to stay kind of where they are for a while, but hopefully, by the end of the year, we start to see things loosen up a little bit.

Operator

Thank you. If there are no further questions, I will now turn the conference over to Mark Sheahan.

Mark W. Sheahan - Graco Inc. - President, CEO & Director

All right, well, thank you very much for participating in today's call. And look forward to chatting with you next time.

Operator

This concludes our conference for today. Thank you for participating. Have a nice day. All parties may now disconnect.

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