GRACO, INC.

Moderator: Pat McHale
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10:00 am CT

Coordinator: Good morning and welcome to the First 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 is 7118428. The replay will be available through May 1, 2017.

Graco has a additional information available in a PowerPoint slide presentation which is available as part of the Web cast player. As a request of the company we will open the conference up for question and answers after the opening remarks from management. During this call various remarks will be made by management about their expectations, plans and prospects for the future. These remarks constitute forward-looking statements for purposes of the Safe Harbor provisions from the Private Securities Litigation Reform Act. Actually results may differ materially for those indicated as a result of various risk factors including identified in Item 1A of the company's 2016 Annual Report 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 www.graco.com, the SEC's Web site at www.sec.gov.

Forward-looking statements reflect management's current view and speak only of the time they are made. The company undertakes no obligation to update these statements in light of the new information of future events. Today's call is recorded. I will now turn the conference over to Pat McHale, Vice President, Corporate Controller and Information Systems. You may now go ahead.

Pat McHale: Good morning everyone. I'm here this morning with Pat McHale and Chris Rothe. Our conference call slides are on our Web site and provide additional information on our quarter. Graco sales for the first quarter of 2017 totaled $341 million -- an increase of 12% from the first quarter last year and net earnings totaled $61 million -- an increase of 54%.

Diluted earnings per share were $1.05 which included 5 cents from a required change in accounting for stock compensation and 1 cent from reduced intangible amortization expense relating from the impairment charge recorded in the fourth quarter of 2016. Foreign exchange was a slight headwind in the quarter and the effect of foreign translation rates reduced sales by approximately $4 million and net earnings by approximately $1 million.

As a result of strong factory performance and realized pricing our gross profit margin rate increased by more than a percentage point from this quarter last year. We have not yet seen the effect of rising commodity prices though if commodities remain elevated as compared to last year we will begin to see some affect in the second half of the year. We have a variety of cost reduction activities underway as we always do and we believe that these cost reductions will largely offset the effective rise in commodity prices this year.

Operating expenses were slightly lower than last year due to the effective currency translation, lower amortization expense and lower stock compensation and warehouse expense. A reconciliation of our operating earnings is included on Page 7 of our slide deck. The effective tax rate for the quarter was 26%. I mentioned earlier the 5 cent effect on EPS related to the adoption of the new accounting standard related to stock compensation.

With the adoption of new accounting standard $3.7 million of excess tax benefits related to stock option exercises that would have been credited to equity under the old standard have now been credited to the tax revision reducing the effective tax rate by 4 percentage points. Without that accounting change the effective tax rate was 30%. Since this benefit is recorded when stock options are exercised the effect will vary from quarter to quarter.

Excluding any effect from the change in accounting for stock compensation the effective tax rate for the second quarter and the full year is expected to be approximately 30%. Net cash from operations totaled $50 million -- up from $29 million last year. Eight-hundred and fifty thousand shares of stock were repurchased in February through an accelerated share repurchase plan and $550,000 shares were issued resulting in a net cash outlay of $60 million. We may or may not decide to make further share repurchases and we'll evaluate a variety of factors before making that decision. I'll turn the call over to Pat now for further discussion.

Pat McHale: Thank you Carol and good morning everyone. All of my comments this morning are in organic constant currency basis. It was a solid first quarter with growth in every segment in every region of the world and good performance in both developed and emerging economies. We're pleased with the strong start to the year and thank our suppliers, distributor partners, employees and loyal customers for their help in getting out of the gate well.

Because demand was broad based geographically and across product categories and we go into a fair bit of detail in our slide deck I'll focus my comments on a few of the areas where we're seeing headwinds moderate. Our oil and natural gas operations were slightly better than flat year over year so we're hoping that we're seeing the bottom. Most of our exposure in this space has been on the production side so there may be some lag from what others are saying on the exploration side.

Mining provided some growth for our process segment in the first quarter which is a positive sign. Demand in this space can be lumpy quarter to quarter but with higher commodity prices conditions for us should be generally improving. Through discussions with distributors and end-users it's clear the confidence levels domestically are better today than a year ago. Our view is that it's still a bit early to declare that the US industrial economy has fully turned the corner but we are encouraged by the direction of the business.

A few points regarding Graco overall order rates. Incoming order rates were strong every month of the quarter in every region and all segments were in positive territory every month of the quarter. Over the past three years we've called out week to week volatility in order rates. In the first quarter we saw that volatility soften which is indicative to us that the worldwide economy may have some found some footing. But it's only one quarter and we'd like to see more of that week to week predictability as we go through Q2 and into the summer.

Orders through the first three weeks of April continue to be solid. Mindful of a tough Q4 comp we'd like to see good topline performance continue through Q2. One comment specific to our contractor segment contractors off to a strong start this year. You'll recall that we were down slightly in Q1 of last year as new product launches pushed out into Q2. So we have an easier comp in Q1 but we'll have a much more difficult comp in Q2. Notably the 2017 product launches have been well received and we expect these products to contribute nicely to 2017 full year results.

Moving on to profitability incremental margins were outstanding in the first quarter with the industrial and process segments well over 50% and contractors solidly into their 40s. As we discussed before the Graco business model levers nicely at higher growth rates. Over the cycle we expect incremental margins in the higher 30s to low 40s.

Moving on to our outlook based on the solid performance in the first quarter we're raising our full-year 2017 outlook from low single digits to mid-single digits. As always we continue to press forward with our long-term growth initiatives and hope that our outlook for 2017 may indeed be too conservative. Operator with that we're ready for questions. (Chris) you there?

Coordinator: Again once again it's Star 1 to ask your questions at this time. Please disengage your mute function to make sure your signal reaches our equipment. It's Star 1 to ask your questions at this time. We'll pause just a moment to allow everyone to queue up for those questions. And we will take Mike Halloran of Robert Baird.

Mike Halloran: Hey good morning everyone.

Pat McHale: Good morning Mike.

Pat McHale: Hey.

Mike Halloran: So just a couple questions here on sustainability Pat, some good color there with trends through the quarter, lessening volatility. You know, in your view do you think there's anything in the revenue line in the first quarter that assuming things stay about on the footing they are today that wouldn't imply normal sequentials as you work forward in any of the segments?

Pat McHale: No business conditions seem to be pretty good and pretty healthy across most of our end markets and across most of our geographies, didn't see anything really strange in the first quarter. It's nice to see, you know, some strength across the board. We haven't really seen that consistently for the last I don't know, couple years anyway. And so, you know, I've got some optimism going to Q2 but it's early and we'd like to see the continue before I ring any bells.

Mike Halloran: No absolutely that makes a lot of sense and then the same question on the profitability side. You know, as are 35 to low 40s kind of incrementals. You know, maybe some thoughts on in particular the process segment where the incrementals were obviously a lot higher in the first quarter relative to that number coming off a more depressed base. Is the first quarter the right base to think about on a process side on a forward basis relative to the revenue levels we're at right now?

Pat McHale: So whether you're talking about the process segment or Graco overall, you know, we've talked many times before is that we lever a good on volume.

Mike Halloran: Yes.

Pat McHale: And when our volume is low it's hard to drive profitability. You know, we don't do big restructuring activities every time we have a bad quarter. We kind of stick to our knitting and invest in our growth initiatives. But when we get good revenue performance we flow a lot through to the bottom line. So, you know, we believe that over the long term that high 30s to low 40s is the right kind of flow through to think about. In quarters where we exceed on the top line you're more likely to see higher flow through and on quarters where we're weak you'll see less. And I think the model hasn't changed.

Mike Halloran: Last quarter you talked about some - last couple quarters you talked about some just factory oriented constraints on the contractor side that might compress that incremental margin a little bit just because you're running so high relative to what's been really good volumes there. Is that still the case or is - or are you able to free up a little room?

Pat McHale: No we've done some things to give ourselves a little bit of breathing room up there. We have enough capacity to produce the demand this year. You know, it's always a challenge in manufacturing to make sure you have parts and all the other things that can go wrong. But from a space standpoint we've added a little bit of storage space and moved some things out so I'm not concerned about it.

Mike Halloran: Great, makes sense. Thanks for the time.

Pat McHale: Yes.

Coordinator: Up next from Oppenheimer we'll go to Jim Giannakouros.

Jim Giannakouros Good morning everyone.

Pat McHale: Good morning.

Jim Giannakouros Very nice quarter specifically on the cost side, cost management. So I guess my question there is is there anything or how should we be thinking about the SG&A progression the rest of this year relative to 1Q?

Christian Rothe: Hey Jim it's Christian, good morning. So with regard to the progression on expenses we've got a pretty decent baseline that's already been set forth. As Pat said, you know, we don't have necessarily all the changes but we are going to have the amortization. That's obviously going to be lower in Q2, Q3. And in addition to that of course whatever assumptions you make on the volume side we'll of course make changes around SG&A.

Jim Giannakouros Got it. Okay. And, you know, at the plant level in the past you've spoken about in - your internal goal to achieve zero cost manufacturing the increase each year. Is that in your current plan and if you can talk about the puts and takes there that'd be helpful. Thank you.

Pat McHale: Yes this is Pat. Generally as far as I can remember that's in our plan every year and so we always have the usual pressures with some wage increases and medical cost increases. Some years commodities help us, some years they hurt us. This year we're expecting that they'll be a headwind for us but the volumes should help the factories certainly on overhead absorption. And volume also helps us drive additional cost reduction activities. I would anticipate that as we go through this year we're going to see more factory requests for machines that'll improve quality and drive up cost. Particularly in the second half of the year I would anticipate some increased CAPEX and some costs associated with that. But those are the kinds of things that help us achieve zero cost change. And with volume I think we've got a real good chance of hitting that.

Jim Giannakouros Got it thank you. And one more if I may when thinking about I guess the margin potential in each segment starting with industrials factoring (gain is) I think it's 300 to 400 basis points kind of weight on industrial margins, seems that you're at or above prior peak now. You know, if you can comment if there's a potential expansion potential there? And I guess same question for contractor appreciating that mix has kept the segment potential below prior peak if I recall.

Christian Rothe: Sure Jim. This is Christian again. So with regard to industrial really to get margin expansion on the margin operating line we can still do it but we do definitely need to have a higher growth rate and it's going to be basis points as opposed to percentage points. On the contractor business we still feel like that business, you know, as we get higher volumes we can get to the mid-20s on operating margins. I'm not sure how much runway there is beyond that. On the process segment, you know, again that's volume dependent but we believe that we can be back in the 20s.

Jim Giannakouros Thank you.

Christian Rothe: And those are all over the medium to long term of course.

Jim Giannakouros Got it. Thanks guys.

Coordinator: And our next question comes from Deane Dray of RBC Capital Markets.

(Jeffery): Hi this is (Jeffrey) on for Deane Dray. My question is about your revised 2017 outlook. I noticed your incrementally more positive on process in all regions in industrial America. Wondering if you can just kind of talk about what you're seeing there and kind of the tone and if America's pretty broad-based is what you're seeing?

Christian Rothe: Yes hi, good morning. This is Christian. So the incrementally positive obviously it's based off of what we're seeing on the incoming orders. We're seeing, you know, the shipment levels go up. And we did see a pretty decent broad-based growth on especially in the process segment. But that's really - and I think you're talking about our current environment in outlook slide in our slide deck. That'd be Slide 11. So we did feel like going from reds across the board on process to something that had more yellows and it seemed appropriate to us.

As Pat said oil and natural gas was just above flat for the first quarter. We'd like to see some more improvement in that area before we feel like we're really seeing things getting incrementally better. The remainder of the businesses and process though did have a solid performance in the first quarter. Around the America's industrial business again I think we've made some comments about the fact that it does seem like there's a better confidence level out there which is great but again we're looking to see more as we go through Q2 and into summer.

(Jeffery): Okay great. And a follow-up industrial you also noted some of the improvement was due to some promotion timing. Can you just talk about what those were and if there's any polling from Q2?

Christian Rothe: Promotion activity happens for us all the time so it's not an unusual thing. It's not really a pull-in either. You know, that we're talking about changes that are not dramatic.

(Jeffery): Okay thank you.

Coordinator: And we'll take our next question from Matt Summerville of Olympic Global - I'm sorry, Olympic Global Advisors.

Matt Summerville: Thanks, a couple questions. First can you quantify I believe it was an $8 million impact you had I think in the second quarter of '16 associated with your new product loading contractor? Can you provide a similar quantification for what you thought that was in Q1 of '17 and then maybe just some color around the types of new products you've been launching in that space?

Pat McHale: Yes we didn't have a launch in Q1 of '17 that was anywhere similar to what you saw in Q2 so I'd say basically not an impact for us in 'Q1. New products that are being well received that are launching in particular in the contractor division include a new generation of handheld paint sprayers. We're pretty excited about that. You know, we launched a original version a number of years ago and we've upgraded the performance and capabilities on that a couple three times here. So we've got an all new one that we've launched this year to good reaction.

We also have a low-pressure tip which really provides some nice benefits to contractors to be able to atomize paint at low pressures, gives them less over spry and the ability to run their pumps at a lower pressure also should give them more life. So we've got some other products as well. I don't want to sit here and spend all my time talking about new products but generally the slate of new products on CED have been well received and should help us throughout the year.

Matt Summerville: Did you get the sense that the level of spend you're seeing in industrial and I think you mentioned in your press release you maybe had some promotional activities in the Americas but just are you starting to see customers adding incremental productive capacity or are you seeing more recapitalization of existing production line?

Pat McHale: So what I'm hearing is more optimism. I'm not sure that we're seeing a big turn in investment yet but really looking at the results of the other industrial companies that have been reporting I got to say I'm feeling pretty optimistic. It looks like most people are seeing an inflection point here and better domestic industrial activity. We're seeing that as well. Again I hate to get too excited over one quarter but I think the direction looks good and let's see what happens going forward.

Matt Summerville: And then just last thing maybe just to clarify if you look at kind of the normal if you will earning seasonality for Graco typically Q1 is the low point. Is there any reason to believe based on what you've seen year to date through the first three weeks in April that Q1 is not the low point of the year or do we need to bear in mind that comp in Q2 you faced in contractor and the fact that you had, you know, one extra week last year versus this fiscal year? Thank you.

Pat McHale: No I remain relatively optimistic at this point that the normal cycle should prevail.

Matt Summerville: Thanks Pat.

Coordinator: Our next question comes from (Siri Boradiski).

(Siri Boradiski): Thank you. Good morning. You had some really strong growth in APAC industrial in the quarter. Could you just talk about what you're seeing in that market and how you're thinking about growth going forward?

Christian Rothe: Good morning (Siri) this is Christian. So with regard to the industrial Asia-Pac, you know, this really is a continuation of what we've seen over the last maybe two years which is pretty good project activity coming through. And I think our team continues to feel like that market is finding footing in that we're going to be able to build a base off of this. And so that was positive. Now we've always cautioned folks that if it - if we have a lot of growth driven by project activity it's going to be spotty from quarter to quarter. We've had, you know, a good string here but let's just be cautious that you could have variability.

(Siri Boradiski): Okay, I appreciate that. And then I just going back to the oil and gas markets, you know, you had slight growth in the quarter so maybe if you could provide any additional color on, you know, what you're seeing in that market and how to think about that for the rest of the year?

Pat McHale: Generally our exposure on direct oil and gas isn't very big. So I would say if you're looking for color on oil and gas market there's a lot better people to talk to than us. You know, we see a very, very small slice of it. And looking at and our shipments and incoming order rates I guess we more or less called bottom here in first quarter at least for us and we hope that that turns out to be the case.

(Siri Boradiski): Okay congratulations on the quarter. I'll go back - get back in Q2.

Pat McHale: Thanks.

Coordinator: And a reminder again to get back into the queue you can press Star 1 at any time. And we'll go next to (James Hicario).

(James Hicario): Hey guys.

Pat McHale: Good morning.

(James Hicario): Just a quick question on price cost. I mean you guys mentioned material inflation likely emerging in the second half a bit but should be offset by cost out actions. Could you just talk about or maybe quantify what - how you're thinking about that material inflation in the back half?

Pat McHale: Yes, you know, again the Graco model we have some advantages right out of the gate in terms of the percentage of a revenue dollar that's really related to raw materials with the gross margin that we have and the high value add that we have in our factories. We're not as whipsawed by commodity price changes as some other folks might be. We generally have good cost reduction programs going on by our factory folks. And what we're seeing in commodity prices to us looks like something that we're going to be able to handle for the year. Certainly if you - and that's really talking about factory performance with the volume and the cost reduction projects. If you take a look at price cost, you know, we do an annual price increase. We run that at the beginning of the year. We did at the beginning of this year so I feel like we're going to be in just fine shape.

(James Hicario): Understood and then just on cap allocation deals obviously, you know, remain elusive. I'm just wondering what, you know, what you see in the pipeline there if anything. And then on buybacks, you know, you committed in that $60 million in the first quarter. How are you thinking about that going forward? Thanks.

Pat McHale: So I'll talk a bit about deals and then Chris you can talk about the buybacks. But on the deal side there are - there is activity out there. We do have an active process inside the company. Multiples remain high so whether we're going to bring any home or whether we're not I guess time will tell. But there are things that are out there for us to look at and we do have some niche markets that we're interested in. So we're going to run our normal drill on that. And Christian you want to talk about...

Christian Rothe: Sure on the buybacks, you know, as it was mentioned already we did do a small ASR in the first quarter. That's still of process. It hasn't concluded yet but it's probably - it is not going to offset the creep for this year. We will continue to evaluate whether or not we want to jump back in and buy more the remainder of this year. It's dependent on a number of factors including internal modeling and what's going on in the broader marketplace. So haven't ruled it out but we are just continuing to look at all the factors.

(James Hicario): Thanks.

Coordinator: We'll go next to (Charlie Brady).

(Charlie Brady): Hey thanks. Good morning guys.

Pat McHale: Good morning.

(Charlie Brady): Gosh I think I guess the only one I really have is a touch back on the prior question on mix within contractor. And you talked about high low, you know, low medium high kind of margin/mix. And previously that, you know, given the recovery that really hadn't - the mix of the high end higher margin had still kind of been a little bit below where it was may be past cycle or past cycle peak. Any granularity and kind of has that moved around a little bit at all?

Pat McHale: You know, Q1 we had, you know, good performance by both paint channel and the home center channel -- pretty even performance between the two. We do continue to see volumes going up on the higher dollar equipment. But frankly we continue to do very well on the low end of the pro side as well. So I'd say if you look at the mix compared back in 2006 we're still skewed towards the bottom on the pro end. But both part of the product lines are growing.

(Charlie Brady): Hey that's helpful thanks. And just one more I guess just in contractor, you know, you've got obviously one pretty big competitor out there. Do you see any irrational behavior from them or is it pretty rational market?

Pat McHale: Well I think the environment across our competitive lines is stable and we've got good competitors across all of our product categories and we're out there beating each over - beating each other over the head every day with a log and I don't really see anything different.

(Charlie Brady): Thanks.

Coordinator: And we'll go next to (Walter Lipta).

(Walter Lipta): Hi, thanks. Good morning guys. Hey I wanted to ask about the, you know, mid-single digit revenue guidance and, you know, with the way the first quarter came through I wonder why you didn't go to high single digit number? You know, I mean I understand the comp that you're going to be going up against in contractor but, you know, everything seems positive. You might get the more cyclical recovery this year. What was the thought behind the mid-single digit?

Pat McHale: I hope you're right. You know, it's been a slog the last couple of years as you know. You know, we've done okay but every day it's been carrying a big bucket of rocks up the hill. So one quarter that we have is really good and incoming order rates still holding up but maybe it's just our natural conservatism but we're just we're going to take it a step at a time here.

(Walter Lipta): Okay that's great. Is there any visibility you can share with us on, you know, orders or quotes in some of the more cyclical businesses? You know, you kind of mentioned oil and gas but, you know, natural gas mining. Is there better activity there?

Pat McHale: Yes mining we're seeing a little bit better activity. Incoming order rate in April has been solid. You know, so in general I'm feeling pretty positive about things.

(Walter Lipta): Okay great. Thank you.

Coordinator: And a quick reminder if you'd like to ask a question at this time simply press Star 1. And we'll go next to Jim Fountain.

(John Fountain): Hi, great quarter. Looks like you answered all my questions. But I guess maybe you could answer this. Did you suspect any inventory building in the first quarter or could we just take that as just pretty much or end market demand and just great organic growth there?

Pat McHale: Yes I think that's mostly end market demand. Obviously when things are on the upswing people may put a little more product on the shelf. But I don't think it was anything that was significant in Q1.

(John Fountain): Okay and then besides oil and gas and mining were there any other large markets that didn't come back for you in Q1 that could help you in Q2 and the rest of the year?

Pat McHale: Well one market that remains soft, it's not a large market for us but is important is the a market. I'm not anticipating that that's going to come back in Q2. I think that's probably going to continue to perform like it has here in recent quarters.

(John Fountain): Okay but there's potential for upside. And then anymore color on M&A? I think you talked about, you know, a question on capital allocation but anything - you close to anything or would you be disappointed if you didn't do something this year?

Pat McHale: No I mean I try not to be too excited or too disappointed with what we get done. What I want to do is I want to see good activity by our team here in terms of identifying market niches that are interesting in doing their work. You can't predict these things. And, you know, if it becomes a disappointment that puts us at risk of overpaying just to get something done. So we're just running our standard program and if something happens it happens and if it doesn't we'll run the rest of our record organic program which is a good program as well.

(John Fountain): Okay terrific. So great job. Congratulations in the quarter.

Coordinator: There are no further questions in the phone queue at this time so I'll turn the conference back over to Pat McHale.

Pat McHale: All right very good. Well one behind us, three more to go for the year and we're going to continue to work hard so we'll talk to you again late July. Thanks.

Coordinator: And this does conclude our conference for today. Thank you for all participating and have a nice day. All parties may now disconnect.

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