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GGG.N - Q1 2023 Graco Inc Earnings Call

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OVERVIEW:

Co. reported 1Q23 sales of $530m, reported net earnings of $129m and diluted EPS of $0.75. Expects full-year 2023 organic revenue growth on constant-currency basis to be low-single-digit.

CORPORATE PARTICIPANTS

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

Kathryn L. Schoenrock *Graco Inc. - Executive VP of Information Systems, Corporate Controller & and Principal Accounting Officer*

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

CONFERENCE CALL PARTICIPANTS

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

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Saree Emily Boroditsky *Jefferies LLC, Research Division - Equity Analyst*

Walter Scott Liptak *Seaport Research Partners - MD & Senior Industrials Analyst*

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 visiting the company website at www.graco.com. Graco has additional information available in a PowerPoint slide presentation, which is available as part of the webcast player. (Operator Instructions)

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 2022 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 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 Kathy Schoenrock, Executive Vice President, Corporate Controller and Information Systems.

Kathryn L. Schoenrock - *Graco Inc. - Executive VP of Information Systems, Corporate Controller & and Principal Accounting Officer*

Good morning, everyone, and thank you for joining our call. 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.

Yesterday, Graco reported first quarter sales of $530 million, an increase of 7% from the first quarter of last year. The effect of currency translation decreased sales by 3 percentage points or approximately $11 million. Reported net earnings increased 28% to $129 million for the first quarter. Diluted earnings per share were $0.75, an increase of 29% over last year.

The gross margin rate increased 230 basis points in the quarter. This improvement was primarily the result of the pricing actions we have taken over the past 15 months as well as improved product and channel mix, which is mainly coming from our Contractor segment. Input costs remain elevated. However, our pricing actions have taken hold, and we are seeing improvements in our gross margin rate as a result. At similar costs and volumes, we expect that the gross margin rate improvement we experienced in the first quarter will continue throughout the remainder of the year.

Total operating expenses increased $2 million in the quarter. Operating expense leverage, along with top line growth and gross margin rate improvement led to operating earnings growth of 22%. Interest expense decreased by $4 million in the quarter. This decrease relates to the prepayment of $75 million of our private placement debt that occurred in the first quarter of last year.

The adjusted effective tax rate was 19.5%, which is comparable to the fourth quarter of last year. Cash provided by operations totaled $91 million, an increase of $60 million from last year, primarily driven by net earnings improvement and a reduction in inventory purchases. We also made dividend payments of $39 million and capital expenditures of $38 million.

A few comments as we look forward to the rest of the year. Based on current exchange rates, we expect the effect of currency translation would have no impact on net sales or net earnings 2023. The unfavorable effects of currency expected in the first half will be offset favorable impacts in the second half. We now expect unallocated corporate expense to be approximately $34 million to $37 million. This updated range reflects higher stock compensation as a result of changes in market-based valuation assumptions.

Our full year tax rate is expected to be approximately 19% to 20% on an as-adjusted basis and finally, capital expenditures are estimated to be $200 million with $130 million related to facility expansion projects.

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. Good morning, everyone. All of my comments this morning will be on an organic constant currency basis.

Sales were up 10% for the quarter, and we achieved record first quarter revenue and operating earnings. We saw revenue growth in all segments and regions with the exception of Asia Pacific, which had soft demand at the beginning of the year in both the Industrial and Contractor segments.

In Asia Pacific, many of our key end markets remain strong, such as e-mobility, battery, alternative energy and electronics. However, these are more than offset by softening sales in construction and powder finishing. As the quarter progressed, incoming order rates rebounded and we anticipate growth in the region on a full year basis.

Pricing actions implemented this year drove sales growth and gross margin expansion during the first quarter. Our strong price realization across all businesses and regions, along with favorable price mix in contractor, resulted in a meaningful improvement in our gross margin rate, which has risen to normal Graco levels that were last seen in the first quarter of 2021. These improvements, along with good expense management, resulted in company-wide incremental margins of 80%.

Operating earnings, expressed as a percentage of sales, were 30% for the quarter, which is the highest in company history despite continued foreign currency pressures. Our pricing strategy over the past couple of years has been to cover rising input costs and to restore the gross margin rate to pre-inflationary levels. With similar volumes for the rest of the year, we should see continued strong margin performance.

Our consolidated backlog was $350 million at the end of the quarter, which is consistent with where it was when we ended last year. While supply chains are improving, we still have shortages in key components, such as electronics and castings, which have prevented our backlog from returning to more normalized levels.

Now turning to some commentary on our segments. The Contractor segment had mid-single-digit revenue growth, resulting in first quarter records for both revenue and operating earnings. Our pro paint and high-performance coatings and foam businesses remained strong, but were partially offset by ongoing softer conditions in the home center channel. This change in demand at the home centers was not unexpected given the large ramp in business we've experienced since 2020.

Growth in EMEA during the quarter was a bright spot as product availability improved and they had strong price realization. Asia Pacific, on the other hand, declined 8% as the shipping container business and construction markets have weakened. As expected, new single-family housing starts in North America have slowed during the quarter, but improving commercial and multifamily residential were more than enough to offset the decline. Professional painting contractors remain busy with order books extending throughout much of 2023 and even into 2024 for commercial applications.

Operating earnings were 30% during the quarter as CED benefited from selling larger pro paint sprayers and fewer home center units. Pricing actions also contributed favorably in the quarter versus what we experienced last year. Incremental margins in Contractor were more than 100% in the first quarter.

The Industrial segment grew 7%, resulting in record first quarter revenue and operating earnings. Our liquid finishing and sealant and adhesive businesses led the way but were partially offset by lower systems sales in our powder finishing business, especially in Asia Pacific. Backlog in powder equipment systems remains elevated overall, which should offset the softer start to the year. Additionally, we expect to benefit from new product releases in the back half of this year.

The Process segment grew 16%, resulting in first quarter records for both revenue and operating earnings. This is the ninth consecutive quarter that Process has set these records. Continued broad-based sales growth in vehicle service, industrial lubrication, process transfer pumps, environmental and semiconductor drove the strong performance.

Pricing actions taken, along with careful expense management, drove 75% incremental margins for the quarter and resulted in 30% operating margins which is a record for the segment. Momentum continues to build as project activity in lubrication, environmental and process pumps are robust, backlogs remain elevated, particularly in semiconductor, and there is excitement around our recent upcoming new product releases.

Moving on to our outlook. We are encouraged by the start of the year. End market activity and demand for our new and existing products remain solid. However, given the volume comparisons in the second half will be more challenging as we lap some of the price increases we took last year, we'll continue to watch incoming order trends in business temple as we remain optimistic for growth in both sales and operating earnings for the full year. Therefore, we are confirming our outlook of low single-digit organic revenue growth on a constant currency basis.

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

QUESTIONS AND ANSWERS

Operator

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

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

Just you gave a lot of good color in the prepared remarks regarding end markets, but maybe just take us through on end market performance versus expectations and we can start there?

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

Yes. I think overall, we're really happy with how things played out in Q1. That probably came in a little better than what we were anticipating when we started out the year. I would say that the growth is pretty broad-based across multiple product categories and across most of our business units and regions. Of course, there is some hotter spots and colder spots. But in aggregate, backlog has kind of stayed flat from the beginning of the year, and I guess we're off to a good start. So there's not much more than I can say other than it's been good so far.

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

Got it. And then it sounds -- in talking to the other industrials this quarter, the supply chain improvements have been coming through pretty smoothly. I mean not out of the woods yet, but it sounds like you're still seeing enough pressure in electronics and castings to have to call it out. So some color there, how do you expect that to? And I might have missed it, but did you do the annual price increase in January and when will we start to see that take hold?

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

Yes. Good question. Yes, we do still have a couple of hotspots on the supply chain. I would say it's much better than it was even in like third quarter and the end of the last year. So things are improving, but we have those two areas that you called out are still creating some pressure for us. And I will also say that we're still seeing inflationary pressure. Our costs are up.

We track what we call purchase price variance, which is what we actually pay versus what we thought when we set our budgets and that is still running unfavorable against what we had planned. So our pricing actions have really helped to offset that. We did implement price increases at the beginning of the year selectively, not across the board, but in a number of the businesses and in the regions. So that should help as we work through backlogs and they'll start to hit.

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

So this is David, maybe I can offer an antidote to illustrate the supply chain situation. Last week, I spoke with one of our factory managers and she drew a comparison from a year ago to currently what her, I'd say, her gaps were in key products that were keeping her factory from shipping products. And a year ago, she looked at her list, and there were 30 items that were interfering with major items, that we're interfering with the flow of product out the door. She's continued to do that. We probably always do it at Graco. I always have something short. But by comparison, at least in the last week, she was talking about fewer than 10. So lots of progress. I think that would be something that we would see across our system. Lots of progress has been made there. But there still are key gaps, as Mark highlighted.

Operator

Our next question comes from Mike Halloran with Baird.

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

Mike, can you help me make sense of the Process and the Contractor margins, you referenced it, but I mean, awfully robust records in both segments. Probably speak to some of the price cost catch-up reduction in some of the efficiences. But maybe a little bit more help on what drove that magnitude? And then also, how should I think about what's sustainable at those levels?

Obviously haven't been here before. I mean, is this the right run rate to think about on a forward basis? Or are there some puts and takes, mix, whatever it is that changes how we should be thinking about this over the next, call it, remainder of the year moving forward, however you want to think about it?

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

Yes, I'll start off and Kathy and/or David can sure chime in as well. We've done some work around this, just to make sure that we had good information to share with you. It's really what we said in a preamble. It's really a combination of -- in Contractor, it's a combination of the pricing actions that they took, which were substantial. As you recall, they had probably the most pressure from a cost standpoint of any of the other businesses.

And then in combination with that, really nice growth on the professional paint side and the high-performance coating and foam businesses, which were in the industrial portfolio a couple of years ago. And those are higher-margin businesses. You combine that with a decline in the home center business, and that really is the story for contractor on the margin rate there. We think it's sustainable going forward to the extent that we continue to get volumes in at the same levels that we've seen so far this year. And that's really where the wild card is for us on kind of a look forward on gross margin rate in CED. There's nothing inherent that would cause us to be concerned about margin rates other than incoming orders.

On the other businesses or Process businesses, really a great story in that we had growth everywhere. We have -- the way we look at it, there's like four big product lines in there. There's our process pump business. There's our environmental businesses. There's our lubrication businesses. And then there's our semiconductor businesses. And again, it's a combination of the pricing actions that we're taking in those units as well as -- yes, we get more product out the door as the supply chains improved and working through backlog that got to those levels. So I think that there as well, as long as volumes hang in there, we believe that the margin rates that you saw and that we saw in the first quarter should be sustainable.

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

Great. That was super helpful. And then just from the outlook perspective, I could certainly understand the lack of visibility on a forward basis and why it's been a really good quarter. You have that low single-digit thought process. Any areas -- I know you called out Asia, but anything that you would point to in order rates or anything else you're seeing in the business where there would be a sign of greater caution from your perspective? Or is a lot of this just perspective based on leading indicators that don't maybe a part of your business, but are maybe more macro or in the leading indicators?

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

Yes. I would say that -- I would just start off by saying that given the really high percentage of our business is short cycle, forecasting for us is probably just slightly better than going to a fortune teller times. And -- so when we're trying to give our guidance and our forecast, we're really taking into account the things that we hear about in the economy and the input from our teams on what they're seeing in the end market. .

The end markets appear to be pretty good, but there's enough uncertainty out there where at this time, we just feel like it's best and most prudent for us to hang on to our outlook number. We'll take more -- we'll definitely take more business if it comes in and if it does, it's going to be great. But for now, I think that airing on the side of caution makes some sense.

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

Yes, I would agree with everything said I would add that something that we've talked about now for 18 months is this backlog build. And we have seen backlog conversion really beginning in the fourth quarter and good progress here in the first quarter, which, by the way, is what we want. We want to work through backlog because we are a short-cycle business, as you know. And it's part of our value proposition that we strive to be the best in customer service and deliveries.

And so if the -- I would say that backlog conversion continues to be a factor in our business. We do really get back in most of our legacy businesses to the short side a little later in the year. And then we get into the visibility issue that Mark talked about.

Operator

Our next question comes from Saree Boroditsky with Jefferies.

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Saree Emily Boroditsky - *Jefferies LLC, Research Division - Equity Analyst*

Congrats on the quarter. So obviously, margin performance really strong, but Industrial margins maybe saw some pressure versus prior year. Is that a reflection of the higher margin sales in China being weaker? Or is there anything else that we should think about there? And does that reverse as China gets potentially stronger following the first quarter?

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

Well, they are at really high margin rates to begin with, and we're really happy with the profitability of that business. So I kind of view the quarter as being flat 13 weeks. Short time period, there's always some puts and takes mix and other things that go into it. So I have no concerns at all about them being able to sustain or maybe even slightly improve if volumes continue to be where they're at or no higher. .

Saree Emily Boroditsky - *Jefferies LLC, Research Division - Equity Analyst*

Okay. And then obviously, you still have a lot of cash on the balance sheet. You bought back a little shares in the quarter, but just maybe update us on how you're thinking about share buybacks for this year or maybe M&A.

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

Well, I think that as we've discussed before, we have a pretty -- I think our approach to deploying capital has been consistent and we continue to focus on, first, our organic opportunities and you saw an uptick in R&D this quarter and consistent with some of the new product expectations that Mark touched on. We've got a very aggressive CapEx program that's continuing this year with the constraint of our new warehouse in Dayton, Minnesota with game expansions that we've talked about. And we're breaking ground in Anoka where our lubrication operation has. So it's going to be a big year for capital.

As far as the two items you mentioned, I would say on the M&A front, if I had to generalize, conversations and opportunities come to our attention frequently. If you're looking for a little bit of color in terms of the market environment, what I would say is, there are -- there seem to be fewer participants on individual initiatives and projects as far as possible purchases. But I would reinforce -- I think, what we've talked about before, which is good merchandise remains at a solid prices. So hopefully, the kinds of things that we're looking at resemble those sorts of opportunities, but I think that there are deals out there and there are maybe a smaller number of -- there's certainly a small number of nonstrategic participants than before.

As far as lastly, the share repurchase. Our approach for years has been opportunistic. I think we demonstrated, for example, last year that when we think there is an opportunity at good prices, we can be aggressive. We deployed about $1.25 billion in 2022. And yes, I'm glad you saw that we made some modest purchases this year and events will drive our activities over the remainder of the year.

Saree Emily Boroditsky - *Jefferies LLC, Research Division - Equity Analyst*

Looks like it could have been good to do it yesterday, but congrats on the quarter.

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

You talked -- yes, Saree, you told me before, I'm a little slow, right?

Operator

(Operator Instructions) Our next question comes from Matt Summerville with D.A. Davidson Company.

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

Just a couple of questions. Is there any way you can maybe directionally help us a little bit in terms of Graco's overall core growth was an impressive 10% in Q1. Roughly, how much of that is price versus mix versus volume? Is there any way to help us parse that out a little bit? And I guess at the end of the day what we're trying to get at is looking forward, how much incremental price is yet to be realized based upon the timing of the second increase last year plus the portion of the business that was subject to the 2023 price increase?

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

Yes. I think I said in my comments that really most of the growth this quarter came from our pricing actions. And I'd stick to that comment just as an overall, give you some guidance on what's going on there. We did put through two price increases, like you said. I think the second one got put in, in the third quarter -- early third quarter, late second quarter. So we've got some, I'll call it, tailwind up until we anniversary those. But as I said before, too, we did put some pricing in here at the beginning of this year as well. So all in all, we're happy that we do what we did. We're really just trying to offset some of the input costs that we have, and that's where we stand today.

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

And then, Mark, as a follow-up, can you maybe talk about what you saw sell-in versus sell-through in both the professional paint and home center channels as it pertains to contractor and what your view is there on general inventory across those two customer bases, please?

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

From a general perspective, I would say, on the pro units, the sell-in and sell-through was pretty flat, even consistent. So it wasn't like they were building inventory and it wasn't like they were drawing down inventory. So we were sort like our demand was matching what they were experiencing out the door in most of the locations where we have that type of equipment. .

On the home center side, more of the decline on their inventory did impact our results. I think their inventories were down a little bit compared to where we would have expected them to be for Q1. So they're likely experiencing less demand at the store level, and they'll manage their inventories, according to what kind of foot traffic they're getting in the stores. And of course, our -- we're very quick to respond when they do orders. So we're responsive if they make a change in inventory levels, it hits us pretty quickly.

Operator

Our next question comes from Walter Liptak with Seaport Global Securities.

Walter Scott Liptak - *Seaport Research Partners - MD & Senior Industrials Analyst*

Congratulations on the nice quarter. I'm getting on the call a little bit late, so I want to -- so I apologize if you've been over this already. But in Contractor, I wonder if maybe as a follow-on to some of the last questions. Any insight you can give us on sort of the geographic regions or anything besides the place that you could talk about on the volume side?

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

Well, I would say that certainly, Contractor, as we've discussed in other occasions, it's -- there's many segments in the market to consider. And definitely, we saw, as Mark alluded to, we saw some really good strength in here in North America in the commercial and multifamily side of the business, which is an important part of new construction.

We also have seen good business performance in the insulation market and in the protective coating space for infrastructure and the heavy-duty applications. I think one area we've tried to call out is in the regions. Asia has gotten off to a slow start for contractor. And if we had to be more specific, China. And here again in the comments, I think we've talked about the construction market in China, I think we could safely say is going through a little bit of a pause. And we have seen the -- a big opportunity for a contractor in the protective coating side is the container market in country, in China. And that tends to be a boom or robust environment in '21 and '22 were really hot for the container markets and with the, I'll call it, the rebalancing that's gone in, in the world on logistics and getting containers back in the right spot, that's going through a core well right now. So that's another area of softness.

Operator

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. Thank you very much. In closing, I would like to thank Kathy Schoenrock for participating on these calls the last few years and also congratulate her for moving into a new role as Graco's Executive Vice President and Chief Technology Officer reporting into me. I'd also like to congratulate Chris Knutson, who many of you know through his excellent efforts leading Investor Relations over the last few years. Chris will become our new Executive Vice President and Corporate Controller reporting to David Lowe.

I'm excited about the energy and focus that these two people will bring to their jobs. They're very important for Graco, and we're excited to get them into those roles. So with that, we'll conclude the call. Thanks for participating. Have a great day.

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

Thank you.

Kathryn L. Schoenrock - *Graco Inc. - Executive VP of Information Systems, Corporate Controller & and Principal Accounting Officer*

Thank you.

Operator

Thank you. This concludes our conference for today. Thank you all for participating, and have a nice day. All parties may now disconnect.
