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GGG - Q2 2012 Graco Inc Earnings Conference Call

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OVERVIEW:

GGG reported 2Q12 sales of \$268m, net earnings of \$34m or \$0.56 per diluted share.



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PRESENTATION

Operator

Good morning and welcome to second quarter 2012 conference call for Graco Inc. If you wish to access the replay for this call, you may do so by dialing 1-800-406-7325 within the United States or Canada. The dial-in number for international callers is 303-590-3030. The conference ID number is 4548978. The replay is available through July 30, 2012. Graco has additional information available in 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, and Exhibit 99 to, the company's 2011 Annual Report on Form 10-Q, 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/ir 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 statements in light of new information for future events. I would now like to turn the conference over to Caroline Chambers, our Vice President and Controller. Please go ahead.

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

Good morning, everyone. I'm here this morning with Pat McHale, Jim Graner, and Christian Rothe. I'll start by providing some top level discussion of our overall financial results for the second quarter, and since this is the first quarter that the new Powder Finishing business is consolidated, I'll note the effect of that business and the effect of purchase accounting and acquisition relating items also. I'll follow with a brief discussion of the accounting implications of the Federal Trade Commission's Hold Separate Order for the Liquid Finishing business and how that investment is presented in our financial statement.



I'll be happy to review further later in the call if you have additional questions. Slides are available to accompany our call and can be accessed on our website. Page four of our slides provides an overview of how our consolidated results -- and also notes acquisition-related items. There's further discussion of the impact of the Powder business on pages five and six as well. Sales totaled \$268 million for the quarter, including \$31 million for the Powder Finishing business.

Changes in currency translation rates had a significant impact on the quarter, and decreased sales by approximately \$7 million and decreased net earnings by approximately \$3 million. Net earnings totaled \$34 million or \$0.56 per diluted share for the quarter. Cost and expenses related to the acquisition led to lower earnings as compared to last year. Gross profit margins as a percent of sales were 52% for the quarter, down 4 percentage points from the second quarter last year. Nonrecurring purchase accounting effects, totaling \$7 million related to inventory, reduced the margin rate by approximately 3 percentage points for the quarter.

Unfavorable currency translation effects reduced the margin rate by approximately 1 percentage point. Realized pricing and improved factory efficiencies more than offset higher costs as compared to last year. Again, we can review this during the question-and-answer section of the call if anyone likes. Total operating expenses increased \$13 million for the quarter. Powder operations accounted for \$8 million of the increase, of which \$2 million was intangible amortization. The amortization number is a good run rate for the rest of the year.

And beyond 2012, I would draw your attention to the 10-Q that was filed momentarily and which gives the anticipated amounts for all of 2012 and going forward. Our unallocated corporate expenses include stock compensation, pension and contribution to the Graco Foundation, as well as acquisition transaction costs.

Acquisition expenses were \$7 million in total for the quarter this year, an increase of \$5 million from the prior year. We see unallocated corporate expense running at \$5.5 million to \$6 million per quarter going forward. Included in other income are \$4 million of dividends, post-tax, received from the Liquid Finishing business that is required to be held separate from Graco and which is accounted for as a cost method investment. Interest expense increased \$4 million for the quarter due to higher levels of borrowings.

The effective tax rate of 32% is consistent with the second quarter last year. This year's rate is reduced by the effect of the investment income from the Liquid Finishing business that is held separate. Last year's rate was reduced by the effect of the federal R&D credit that is not available in 2012. Again, there is additional detail in the slides that accompany our call and note the major items that affected the quarter. Page seven of the slides includes information about changes in net sales by region as well as sales by currency for Q2 2011 and Q2 2012.

Our usual slides about our segment results are also included starting on page 15 of the slide deck. Net cash provided by operating activities was \$65 million for the quarter in 2012, as compared to \$44 million last year. Inventory levels stabilized in the first half of 2012 after increasing in 2011. Increases in accounts receivable moderated compared to the first half last year.

Capital expenditures are \$12 million year to date and we expect capital expenditures to be between \$20 million and \$25 million for the full year. We paid dividends of \$27 million in the first half of the year, and to note, we continue to expect that we will make a voluntary contribution to our US funded pension plan in the range of \$5 million to \$10 million later in the year. In March, our prior \$250 million credit agreement was terminated in connection with the execution of a new unsecured revolving credit agreement that provides up to \$450 million of credit.

On April 2, we paid \$660 million to complete the acquisition of the finishing businesses from Illinois Tool Works, using available cash and \$350 million of borrowings on the new credit agreement. In July 2012, we also made an additional payment of \$8 million representing the difference between cash balances acquired and the amount of cash that was estimated at the time we closed. Assets acquired in the acquisition include that \$18 million of cash, of which \$6 million was available to the Powder Finishing operation.

I'll take a moment to provide some background on the accounting for the Liquid Finishing business and the implications of the Hold Separate Order from the Federal Trade Commission. The acquisition included both a Powder and Liquid Finishing operation. Under the FTC Order, the Liquid Finishing business is held separate from the rest of Graco's businesses.



In May 2012, the FTC issued a proposed Order that would require Graco to sell all the Liquid Finishing business within 180 days of the issuance of the final Order. The final Decision and Order has not yet been issued. Under terms of the Hold Separate Order, we cannot exercise direction or control the operations of Liquid Finishing, nor are we able to exert significant influence over the Liquid Finishing operation.

Consequently, the \$427 million investment in the Liquid Finishing business has been reflected as a cost method investment and its financial results have not been consolidated with those of the company. Income is recognized based on dividends received from current earnings, post-tax, and \$4 million of dividends were included in other income in Graco's income statement in Q2.

We have provided some additional high level information on the financial performance of Liquid Finishing in yesterday's release and in the 10-Q which was filed a little while ago.

With that, I'll turn the call over to Pat McHale for more comments on our overall results.

Pat McHale - Graco Inc. - President, CEO

Thank you, Caroline. Good morning, everyone. There was a lot of noise in the second quarter, the unavoidable result of completing the acquisition of the Powder Finishing business early in the quarter and the unique accounting treatment of the held-separate Liquid Finishing operations. Between the details in our press release and the accompanying slides, as well as Caroline's commentary, I'm hopeful that our investors have a clear view of the individual pieces of our financial statements.

As always, I'll give you some color on the general trends we saw on our business in Q2, and our views on the second half of 2012. In the second quarter, we faced continued, if not enhanced, headwinds in Western Europe and China. On our call last quarter, we indicated that we were hoping that both of these markets had stabilized. The performance in Q2 indicates that they took a step down.

Mostly this is related to underperformance in our Industrial segment in these geographies, which I'll discuss later. As Caroline highlighted, our gross margin on a constant currency basis and adjusted for purchase accounting was essentially flat with the second quarter of last year, with realized pricing more than offsetting material cost increases. I'm satisfied with that number and believe that we're in a good position for the remainder of the year.

As I get into the details of each of our segment results, I'll focus my comments on year-over-year performance on a constant currency basis. Starting with the Contractor segment -- sales grew by 4% worldwide in the second quarter. The North America paint channel was up in the high single-digits with good out-the-door sales performance through the channel. We believe channel inventory appears reasonable, and the overall construction environment is expected to remain positive.

Comparisons to the prior year included \$2 million of the fine finish launch or paint channel numbers would have been up double-digit from the prior year. We have new products scheduled for launch in the second half, which we expect will have more impact than the new products launched in the first half in the Contractor segment.

The timing of these launches is on the bubble between Q3 and Q4, so exact timing is not known. This should provide some upside potential as we exit the year, though. Sales to the home center channel were flat, masked by last year's Q2 load. If you exclude the load, we would have shown a lower double-digit growth rate. As such, I'm satisfied with performance. One-time expenses associated with Q2 2011 initiatives dropped off, improving profitability for the channel and the segment. Overall, we believe that the remodeling environment is improving and we continue to work on sales initiatives to drive growth in the second half.

Moving on to our Contractor business in Europe -- we continue to experience a difficult environment in Western Europe. While growth in Eastern Europe and other developing markets of EMEA has been good, the penetration rates are low and the base is small, so we're not able to offset the headwind in the developed economies, where equipment use is more prevalent. Again, new products may provide some upside late in the year, and the comps for the second half are somewhat easier, as we experienced softening beginning in the second half of 2011.



Overall, we anticipate Contractor Europe to continue its flattish trends at constant exchange rates for the second half, as we expect the negative conditions in the construction market in Western Europe will persist. In Asia Contractor, we're off to a good start and we expect strong single-digit year-over-year growth for the second half of 2012. Moving to the Industrial segment -- note that for purposes of this call, I'll be discussing industrial specifically as the legacy Graco Industrial segment.

I'll cover the acquired Powder Finishing business, which is now part of our Industrial segment, separately. Our overall Industrial segment grew only 1% organically in Q2, with a strong performance in the Americas being offset by weakness in Asia-Pacific. The 7% in growth in the Americas was solid for Q2, with good results across most product lines and end markets. Notwithstanding the macro commentary out there, we feel relatively positive about the Americas for the second half of the year and have mid-single-digit growth expectations.

Europe Industrial is relatively flat in Q2 and we are cautious heading into the second half. We expect Eastern Europe and the Middle East to remain healthy, while we continue to face headwinds from the Western European economy and currency. We are anticipating a low single-digit growth for Europe Industrial in the second half compared to the second half of last year at constant exchange rates. We'll be monitoring our order intake closely, as our business has a short book and ship cycle and the near-term outlook is unclear.

Our Industrial business in Asia was a disappointment in Q2, with particular weakness in automotive project activity in China, India and Korea. Southeast Asia remains generally healthy, with some softness in mining-related orders. We have captured nice opportunities in Japan and expect a decent second half there. We expect India to remain challenging but we do anticipate a pickup in China in the second half. In all, we expect Asia to deliver second half organic growth in the low single-digits compared to the second half of 2011. In both Europe and Asia we are managing expenses carefully, although we have not pulled back on investment in our core strategies.

Now for some commentary on the acquired Powder Finishing business. We're pleased with the performance of the Powder Finishing business in Q2. Although this quarter had a lot of noise in the numbers, the underlying business performed well on the top line and delivered 20% operating margins without the one-time purchase accounting hits. Excluding amortization, the business performed at a mid-20s operating margin. Amortization will remain for a long period of time. This indicates the underlying health of this acquisition.

We do not plan to break out this level of detail in Powder results going forward, but you will get some understanding of its performance as we call out the impact of acquisitions within the Industrial segment. Integration is underway, but recall that our primary goal is maintaining the revenue. We've had no negative surprises and are very pleased with this acquisition as well as the strong management team that we've added to our organization.

Now for some comments on the Lubrication segment. Lube continued its streak of double-digit growth in Q2 with a 15% year-over-year increase driven by the Americas. We had double-digit growth in both the VS and the Industrial Lubrication business in the Americas, with Industrial Lube growing somewhat faster.

The legacy Vehicle Service business saw a good project demand at car dealerships and heavy equipment maintenance facilities and was also helped by new product introductions. The Industrial Lube initiative continues to progress with growth that is driven by an improving economy, new products, and sales initiatives that are gaining market share. While our overall market share remains small in Industrial Lube, our product portfolio continues to improve, and we're pleased with the progress.

Europe Lube was challenging, but our base is small and we have good initiatives in place. Our expectation is that Europe Lube will grow double-digits in the second half as these efforts produce results. Asia-Pacific had a soft Q2, primarily due to some weakness in our Industrial Lube business at a key account, but our outlook is for a better second half and we anticipate double-digit growth compared to last year.

Some comments about our overall second half outlook -- we expect continued solid performance from the Americas in the second half, mid-single-digit growth. Clearly, macro conditions were not as favorable in Europe and Asia during the first half as we originally anticipated, but we do expect both regions to grow organically in the second half in the low single-digit range.



Despite weaker than expected top line organic growth, Graco employees executed well during the first half. Factory performance has been outstanding, and our new product pipeline remains robust. We are in a period of uncertainty and there may be choppy waters ahead for a time. We're confident in our direction and while we will manage discretionary spending carefully during this period, we are not planning to pull back on our key long-term growth investments.

Lastly, I'd like to make a few comments about the Liquid Finishing sale process. We went into a fair bit of detail on the status of the sale process for the Liquid Finishing business in the press release, but I wanted to head off a few questions that we're anticipating.

First, the final Decision and Order from the FTC has not yet been issued. The public comment period ended earlier this month and we are anticipating that the order will be issued in the coming days or weeks, but we don't have any real clarity on the timing.

Second, most of the preparations for the sale are coming together, including the hire of an investment banker, legal counsel and accounting team. We will be ready to launch the process shortly after the Order is issued.

Third, inbound interest has been strong, with calls from multiple strategic acquirers as well as private equity firms. That being said, we believe that a far and wide process could be a major drain on the Liquid Finishing management team and timing is an important factor. As such, we're going to be relatively selective with the parties that are invited into the auction and how we qualify these buyers.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Our first question comes from Charles Brady from BMO Capital Markets. Please go ahead.

Charles Brady - *BMO Capital Markets - Analyst*

Thanks, morning.

Jim Graner - *Graco Inc. - CFO*

Morning, Charley.

Charles Brady - *BMO Capital Markets - Analyst*

Hey, with respect to the new product launches coming out second half, are there any incremental costs that go along with those product launches or have we kind of absorbed that going in front of that?

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

I think there will be definitely some incremental costs, but I believe that unless the timing of the launch gets really late in the fourth quarter, that the revenue ought to more than offset the launches that are -- the costs that are associated with those particular launches.



Charles Brady - *BMO Capital Markets - Analyst*

Okay, thanks. And just your comment on the Industrial segment, the European performance, I just want to clarify something. On slide 15, when you break out the regions for Industrial and you've got Europe \$50 million over \$36 million, \$16 million of that is the Powder business, correct?

Jim Graner - *Graco Inc. - CFO*

Correct.

Charles Brady - *BMO Capital Markets - Analyst*

And so if I back out the \$16 million, Europe is down year-over-year, but has the currency been mixing into there that's skewing it, basically?

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

Yes. On a constant currency basis, they were up slightly in Industrial Europe.

Operator

The next question comes from Jim Giannakouros from Oppenheimer. Please go ahead.

Jim Giannakouros - *Oppenheimer & Co. - Analyst*

Good morning, guys.

Jim Graner - *Graco Inc. - CFO*

Morning, Jim.

Jim Giannakouros - *Oppenheimer & Co. - Analyst*

Lubrication, growing on plan, but operating margin dipped below 20% in the quarter. Was there anything notable on the expense side there?

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

No. Expenses are pretty consistent with the first quarter and, of course, the operating margins are up significantly from last year at this time. The major issue for the second quarter was just some mix and also a little bit of spending that's going on in the factory to put some new capital equipment projects in place. But other than that, I don't have any concerns with the operating performance of the Lube division. They did a pretty good job.

Jim Giannakouros - *Oppenheimer & Co. - Analyst*

Okay, thanks. And you said in material cost inflation, I see aluminum, steel, I see them dropping year-over-year. Maybe you can tell me how -- what I should be tracking to be more in line with what you're seeing on the material side and should you anticipate any reprieve in the second half on that front?

Jim Graner - Graco Inc. - CFO

Yes, this is Jim Graner. We saw modest material pressures in the first half. We expect those to abate in the second half. You're right, the current trends in metals, in particular, are dropping off. So we would think we'd be a little bit favorable from this point forward relative to the first half of the year and relative to the second half of 2011.

Pat McHale - Graco Inc. - President, CEO

Keep in mind, we do have a lag in terms of both upside and the downside, the way our pricing structures are set up with most of our key suppliers.

Jim Giannakouros - Oppenheimer & Co. - Analyst

Is that lag more than the quarter that is implied in your inventory insurance?

Jim Graner - Graco Inc. - CFO

Not really.

Jim Giannakouros - Oppenheimer & Co. - Analyst

Okay. Thank you.

Operator

The next question comes from Liam Burke from Janney Montgomery Scott. Please go ahead.

Liam Burke - Janney Montgomery Scott - Analyst

Yes, thank you. Good morning. Pat, you talked about markets being slightly tougher in certain regions. Are you seeing any price competition? I know you have increased materials cost, you've been able to increase prices, but on the other side of the equation, the competitors, the pricing down, are doing any of that?

Pat McHale - Graco Inc. - President, CEO

We've got competitors that are good across all of our segments and I'd say that the environment is normal, not abnormal. I think we've got normal level of price competition out there.

Liam Burke - Janney Montgomery Scott - Analyst

Okay. And on the -- you mentioned the priority for the powder coatings business is maintaining the inventory -- I mean, excuse me, the revenue momentum that you've had. Operating margins net of amortization are mid-20s. Do you see any low-hanging fruit in the near term to move them more towards the industrial average?



Pat McHale - Graco Inc. - President, CEO

A couple of things in the near term. First, we've got some work to do here to complete the Liquid Finishing sale and make sure that we get everything unwound and realigned correctly. So there's a fairly significant portion of our integration time is related to things that are not necessarily going to be immediately impacting our P&L.

The other thing that I think may have some more shorter-term opportunity, and we've started some of these discussions, is whether or not we can leverage Graco's channel with some Powder or [Vise] -- leverage some of their customers with other Graco business, and that could have some more near-term upside. But I think, really, the upside in the Powder business is over the longer term, as we communicated when we did this deal, is that we really believe that opportunities are going to come over more of a 5-year time horizon.

Liam Burke - Janney Montgomery Scott - Analyst

Great. Thank you.

Operator

(Operator Instructions). The next question comes from Terry Darling from Goldman Sachs. Please go ahead.

Terry Darling - Goldman Sachs - Analyst

Thanks. Good morning, guys.

Jim Graner - Graco Inc. - CFO

Morning.

Terry Darling - Goldman Sachs - Analyst

Hey, Pat, I think I just wanted to true up a couple of points you were making on the outlook. I guess, first, your second half Industrial Europe, I think I heard you say, up -- organic up slightly, which I think is a little bit better than what we had been looking for. I'm just wondering what kind of visibility you really have on that? Has the second quarter got some inventory destock in it that maybe in the second half goes away. How confident, really, are you in that bounce back in Europe Industrial organic in the second half?

Pat McHale - Graco Inc. - President, CEO

Well, our comment on that was that we're expecting low single-digit growth in Europe in the second half and that's on a constant currency basis. We eked out, I think, just a small gain in Europe on a constant currency basis in Q2. I don't think inventory is going to have much impact on it. We may have a little bit of upside with further traction on new products, but there is some uncertainty and we've got a short cycle business. So just like all of you, we're watching it closely and my crystal ball is far from perfect.

Jim Graner - Graco Inc. - CFO

Terry, we only have a look into three weeks in July. Orders in Europe are running ahead of last year's July. So we're not seeing the cleft we saw in 2008. So it gives us confidence in the forecast. We know that there are some projects that are being booked here in August as well. So, again, we have confidence in our numbers that Pat -- as he described them.



Terry Darling - *Goldman Sachs - Analyst*

And is there any color you can provide on kind of Western Europe versus Eastern/Middle East/Africa? Are you seeing Western Europe negative, the others positive in the second half? Are you assuming the others get more positive or Western Europe gets less negative? Any color you can offer there?

Jim Graner - *Graco Inc. - CFO*

Well, in the first quarter, we had some nice growth out of the central part of Western Europe, in particularly, Germany. That disappeared in the second quarter. We are expecting that to stabilize again. I mentioned the projects that look like they will book, should give us some lift and just the overall trend and comments from our distributors. Auto production is up great in the German car factories, in one point of reference. So, the total industrial market there hasn't lost its wheels.

Terry Darling - *Goldman Sachs - Analyst*

Okay, and then from a cost structure perspective, I guess, given potential for weak top line in Europe for a while, are you comfortable with where the cost structure is at this point? Or are there some incremental things you're contemplating there?

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

No, we're taking a look at -- when we have an open headcount position, we're looking at it carefully to make sure that we want to fill a job or that we want to add a job, and we're looking at general discretionary spending. But, currently, I don't have any plans to do -- go out there and take the knife out and cut any significant chunks of headcount out of the organization.

Terry Darling - *Goldman Sachs - Analyst*

Okay, and then shifting to US Contractor, Pat, I guess, you went through a couple details. I wonder if you can revisit that and, I guess, the questions I had were, one, given some of the comments out of Sherwin and guys like that, might have expected growth to be a little stronger. I'm wondering how you would view that dynamic, and I got a follow-up there.

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

Yes. I think, based upon the commentary that we saw coming out of some of the other people that reported, I think we were about in line. If you take a look at growth in both the paint channel and the home center, excluding the launch or the load costs last year from some initiatives, we were up double-digit on both. And when you take a look at what some of those other companies were reporting on a volume basis, I think that kind of slots in there pretty well with that.

So, some of our performance in the second quarter in Contractor was muted a little bit by what happened last year. And I certainly can't say it's going gang busters, but I feel reasonably positive about the direction of that business and I think we've been seeing improvement and I expect that that will continue.

Terry Darling - *Goldman Sachs - Analyst*

And what are you seeing on mix in terms of customers buying high-end equipment versus low-end equipment?

Pat McHale - Graco Inc. - President, CEO

Mix looks okay. It looks all right. We certainly don't have the imbalance that we had back in that 2007, 2008, early 2009 timeframe.

Terry Darling - Goldman Sachs - Analyst

Okay, and then just lastly, did you say anything about what you're expecting for Americas Lube in the second half? And then can you differentiate, for the Lube division overall, what Industrial Lube is growing now versus the legacy business?

Pat McHale - Graco Inc. - President, CEO

Industrial Lube, over the last number of quarters, it has tended to grow a little bit faster, but the Vehicle Services business, which really got hit hard in the Americas on the downturn, has made quite a nice recovery, not quite back up to peak yet. So -- now, we didn't give a specific forecast for Lube in the Americas in the third and fourth quarter. But I'm feeling generally positive and I think they're going to have some better performance in the second, and the third and fourth quarter from Europe and Asia. So, overall, I would look for Lube to continue to perform well.

Terry Darling - Goldman Sachs - Analyst

Okay. Thanks very much.

Operator

The next question comes from Mike Halloran from Robert W. Baird. Please go ahead.

Mike Halloran - Robert W. Baird - Analyst

Morning, everyone.

Jim Graner - Graco Inc. - CFO

Good morning, Mike.

Mike Halloran - Robert W. Baird - Analyst

So a couple here, so first, on just trends through the quarter -- when did you guys start seeing that inflection point on the downward side on your Europe, China businesses? But --- as the first part of that. And the second part is, it sounds like since that inflection point, things have stabilized a little bit, and just curious if that's what the implication is.

Jim Graner - Graco Inc. - CFO

Yes, Mike, we look at orders on a rolling three-month basis, a three-month (inaudible) versus three months last year. The negative point in Asia came in April. It came a month later on our consolidated. Asia did actually go negative for a couple months. It's now back in the positive. The -- in total, consolidated orders never went negative. It got down into the 2% or 3%, and now it's back in the kind of range that we're projecting for our revenue growth for the rest of the year.



Mike Halloran - *Robert W. Baird - Analyst*

Sounds good. And then one quick one on just making sure I understand a couple of the nonrecurring charges here and related to the Powder inventory and intangible amortization. So from the press release, where you guys called out that \$7 million of inventory adjustment on the Powder side, that's the nonrecurring side and that occurs in the industrial side, but that does not include the \$2 million recurring intangible amortization, correct?

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

Yes, this is Caroline. That's correct.

Mike Halloran - *Robert W. Baird - Analyst*

Okay, just wanted to make sure. Thanks, everyone.

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

Operator, are you still there?

Operator

The next question comes from Kevin Maczka from BB&T Capital Markets.

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

Thank you. Good morning.

Jim Graner - *Graco Inc. - CFO*

Kevin.

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

Pat, question. This is the first quarter now we've got ITW. So, we stepped up product development costs a bit; we stepped up G&A a little bit more. I'm just thinking, in terms of run rates going forward, is this a decent run rate now for the G&A in the product development spend, or given what you're planning for new products in the back half, maybe should we see that line continue to move higher?

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

I'll comment on the product development, then I'll let Jim or Caroline comment on the G&A piece. But on the product development side, we did add some resources to our product development effort again for 2012. And at least for myself, I'm projecting that the second quarter spend on product development should be pretty reflective with what we're going to see going forward in the second half. I don't anticipate a big step up or down. G&A?



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

Yes. I made a couple comments on the unallocated portion of that. So we need to take out the acquisition costs. We probably will look to see some divestiture cost going forward, and I think we noted that in our slides. And then also, we did have a little bit higher pension expense going forward. But other than that we expect that part to be in the \$5.5 million to \$6 million range going forward.

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

Okay. And then on Contractor margin, we didn't have the issue this time, but last year we did, where there's a big new product development or new product roll-out, we have displays and store set cost. Do we have something like that coming in the back half as well?

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

Well, those are things we wouldn't talk about in advance unless the whole world knew about them anyway. But I would say that known new product launches that we've got coming out, assuming, again, that they don't come out really late in the year, those initiatives should cover their cost.

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

Okay. And just finally, Pat, can you give an update on where you are with your buy back and what your intentions are there?

Jim Graner - *Graco Inc. - CFO*

This is Jim. So we have been focused on the acquisition and the leverage we took on with the acquisition. So we've been cautious to date that we haven't bought back anything. We still have approximately 4 million shares under authorization, and as the sale process of the Liquid Finishing becomes clearer, we might get more active.

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

Got it. That's what I thought. Thank you.

Operator

The next question comes from Matt Summerville from KeyBanc. Please go ahead.

Matt Summerville - *KeyBanc Capital Markets - Analyst*

Morning. A couple questions. First, with regards to the Powder business, what sort of pro forma or organic growth rates on the top line do you expect from Powder looking out over the next year or two? And then, is there seasonality to that business that we need to be thinking about as we model this?

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

On the top line of the business, so let's exclude our second half forecast and the current environment that we were talking here when we made the acquisition. The Powder business actually had been growing around a point faster than the Liquid business. So I think the underlying growth rate of Powder you could model in that 6% kind of range and have a decent starting point. The second question?



Jim Graner - Graco Inc. - CFO

So on the seasonality, Matt, it's really not apparent. But it is more project-related and it has some lumpiness. For instance, in the third quarter last year, their revenue was the peak for the year, close to \$40 million. I would expect that's not to be at that level this year, just because of the way the projects are laid out. The team there is still confident on growth for the nine months in the 6%, 7% kind of range.

Matt Summerville - KeyBanc Capital Markets - Analyst

And then now that you have -- well, if we just kind of ignore the purchase accounting step up on inventory, it looks like you're pretty comfortable with what the level of intangibles, amortization is going to be like going forward, and it sounds like you've allocated the purchase prices between the Powder and the Liquid piece. Jim, how -- what sort of accretion would you expect out of Powder in the first year of ownership under Graco? Again, let's remove the noise from purchase accounting.

Jim Graner - Graco Inc. - CFO

So, again, ignoring the interest expense, we're going to be close to \$0.10 to \$0.15.

Matt Summerville - KeyBanc Capital Markets - Analyst

So that's prior to allocating the interest expense?

Jim Graner - Graco Inc. - CFO

Correct.

Matt Summerville - KeyBanc Capital Markets - Analyst

Okay.

Jim Graner - Graco Inc. - CFO

So, again, the interest expense is buried in the historical numbers, and to go out and to pull that back out of the historic and add it to the -- or excuse me, subtract it from the Powder's results, I don't think would give a true trend.

Matt Summerville - KeyBanc Capital Markets - Analyst

Right. As you look across Europe and China and some of the areas that have been a little more volatile and problematic, are you hearing anything from your distributor customers about their ability to get bank credit or have access to trade credit in any way?

Pat McHale - Graco Inc. - President, CEO

I can't say that that's been a significant topic of conversation between myself and the operating people as we've looked at the second half forecast. My view on Western Europe, in particular, is that there's just a large level of caution and people are being very careful with their spending, but it's not an issue at the moment that I've heard where they want to spend and they can't get the funds.

Matt Summerville - *KeyBanc Capital Markets - Analyst*

And then just one last question relating to your kind of closing formal remarks, Pat -- how are you feeling about your ability to recoup the investment or do better than that, maybe, that you made on the Liquid Finishing side based on how that's been allocated, the \$427 million, I think, Caroline said. Or does the preference of Graco to move this process forward, it sounded like pretty quickly, once you've received that final order, does that weigh on that probability?

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

I think we're feeling pretty good about our ability to recoup. Again, I have commented about the fact that we've had a lot of people express interest. These are good brands. They've been in the marketplace a long time. They're good cash generators. And the M&A environment still seems to be pretty robust, with good multiples being paid for quality fluid handling businesses. So, I would say, right now, we tend to be more towards the optimistic side.

Matt Summerville - *KeyBanc Capital Markets - Analyst*

Thanks, Pat.

Operator

The next question comes from Jeffrey Matthews from RAM Partners. Please go ahead.

Jeffrey Matthews - *RAM Partners - Analyst*

Yes, I just wanted to follow-up on the credit question. You mentioned the availability. In Europe, doesn't seem to be an issue, but how about in China?

Jim Graner - *Graco Inc. - CFO*

Our receivables there are current. There is some indication that, in particular, the -- I'll call them the more government-sponsored industrial companies are not spending. So it's not a credit issue. It's more of that they're not approving projects. So our business in China is still good with industrial companies outside of -- that are based outside of China. The auto companies there are putting plants in place. Where we're seeing a little bit of delay in projects is coming from those that are more closely aligned with the government there.

Jeffrey Matthews - *RAM Partners - Analyst*

And is that a significant portion of your business or not?

Jim Graner - *Graco Inc. - CFO*

It's substantial. It's not a majority, but it is a nice piece of the business.

Jeffrey Matthews - *RAM Partners - Analyst*

Okay, thank you.



Operator

(Operator Instructions). We have a question from Jim Krapfel from Morningstar.

Jim Krapfel - Morningstar - Analyst

Hi, good morning. Did you give second half growth estimates for Contractor Americas and Contractor Asia?

Pat McHale - Graco Inc. - President, CEO

I did not for Contractor Americas. I just tried to shed some color on what the underlying run rate of the business was in the second quarter without the load, which was in that double-digit range. And again, we have, I think, a reasonably positive outlook in terms of the general construction industry here in North America for the second half compared to last year. In Asia-Pacific, we believe that we should achieve strong single-digit growth performance over last year's second half, which was a good second half for us there.

Jim Krapfel - Morningstar - Analyst

Okay, and then within the Americas portion of Contractor, what percentage of residential construction was that business, maybe at its peak, and where is it now?

Pat McHale - Graco Inc. - President, CEO

There is no way to be able to tell what percentage of residential construction of our sales are because we sell to the painting contractor -- and they could be painting anything, and they can paint different things at different periods of time. So there's no way to really track that. But the three important segments for us, of course, are the remodel, repaint of the install base and then residential construction and then new commercial construction. I can't internally even get a good metric on that.

Jim Krapfel - Morningstar - Analyst

Okay, fair enough. And then finally, what would you look to do with the cash received upon the sale of Liquid Finishing?

Pat McHale - Graco Inc. - President, CEO

Well the immediate thing, of course, we would do is we'd pay down debt. But as Jim mentioned, we are contemplating, once we get some clarity on the sale process, becoming more aggressive on our stock, and we also continue to look for other, I guess, I'll call them high-profit niche acquisition opportunities that might make sense for the organization. So we'll continue to watch our balance sheet so that we keep our debt to EBIT at a level that we're comfortable with. But it should give us some dry powder to do some more active things, both in the acquisition market and in our stock.

Jim Krapfel - Morningstar - Analyst

All right. Thank you.

Operator

There appear to be no further questions. I would now like to turn the conference over to Pat McHale.



Pat McHale - Graco Inc. - President, CEO

All right. Well, thank you for working through a challenging quarter from an accounting perspective with us and have a good week.

Operator

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

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