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GGG - Q1 2019 Graco Inc Earnings Call

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PRESENTATION

Operator

Good morning, and welcome to the First Quarter Conference Call for Graco Inc.

If you wish to access the replay for this call, you may do so by dialing 1 (888) 203-1112 within the United States or Canada. The dial-in number for international callers is (719) 457-0820. The conference ID number is 3050476. The replay will be available through Monday, April 29, 2019.

Graco has additional information available in a PowerPoint slide presentation, which is available as part of their 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 2018 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 that 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 Caroline Chambers, Executive Vice President, Corporate Controller and Information Systems. You may begin.

Caroline M. Chambers - *Graco Inc. - Executive VP of Information Systems, Corporate Controller & Principal Accounting Officer*

Good morning, everyone. I'm here this morning with Pat McHale and Mark Sheahan. Our conference call slides have been posted on our website and provide an additional information that you may find helpful. At actual currency translation rates, sales totaled $405 million for the first quarter, essentially flat to last year. At consistent currency translation rates, sales increased by 2% driven by growth in the Process segment. Reported net earnings totaled $87 million for the quarter or $0.51 per diluted share.

After adjusting for the impact of excess tax benefits from stock option exercises and a non-recurring tax planning item, net earnings totaled $80 million or $0.47 per diluted share.

Gross margin rates decreased by 1.3 percentage points compared to the first quarter last year. Approximately, half of the decline is due to unfavorable currency translation.

Higher material costs and unfavorable product mix also contributed to the lower gross margin rates. Our risk price changes went into effect during the first quarter and price realization improved throughout the quarter, particularly in March.

We expect that the full effect of the price change will be realized as the year progresses. The incremental effect of tariffs and higher material costs for 2019 is now expected to be approximately $21 million. This is in line with earlier projections and after adjusting out the previously planned increase in China tariffs from 10% to 25%.

As noted in earlier quarters, the effect of tariffs varied by segment and is most significant in the Contractor segment. At current factory volumes, we expect that realized pricing and factory operating performance will offset the dollar value of incremental tariffs and material costs for the year.

Product development expenses increased by approximately $1 million as compared to the first quarter last year. Unallocated corporate expenses also increased as compared to last year by approximately $1 million, primarily due to stock compensation.

Incentive expenses were lower in the first quarter as compared to last year. The effective tax rate was 14% for the quarter, a decrease by 6 percentage points when compared to the first quarter last year.

This is primarily due to an increase in excess tax benefits related to stock option exercises and other non-recurring tax planning items.

Adjusted for these items, our tax rate was 20.5%. Cash flow from operations totaled $51 million compared to $59 million in the first quarter last year.

Changes in working capital are in line with seasonal trends, and the decrease in operating cash flows is primarily due to the timing of certain payments as compared to last year.

We implemented the new lease standard in the first quarter and recorded lease assets and liabilities of approximately $35 million on our balance sheet.

These leases are primarily for facilities in various locations.

Capital expenditures were $30 million this quarter with projects to expand certain manufacturing and distribution facilities in full swing.

Looking forward, we expect capital expenditures for machinery and equipment of approximately $40 million for the full year, and our current estimate for facility expansion is approximately $110 million to $115 million for the full year.

At current rates, currency translation will continue to be unfavorable, and the effect in the second quarter could be as much as 2% on sales and 4% on earnings.

The full year effect is estimated to be approximately 1% on sales and 3% on earnings, assuming the same mix of business as the prior year.

We expect unallocated corporate expense to be approximately $31 million for the full year 2019, an increase of $1 million from our earlier projections, primarily due to an increased stock compensation cost.

Our 2019 full year tax rate is expected to be 20% to 21%, excluding any effect from excess tax benefits related to stock option exercises.

I'll turn the call over to Pat now for further discussion.

Patrick J. McHale - *Graco Inc. - President, CEO & Director*

Thank you, Carol, and good morning, everyone. All of my comments this morning are on an organic constant currency basis.

First quarter was below our expectations. However, we are holding to our full year outlook and remain cautiously optimistic regarding the balance of the year.

Some color on the segments. The Industrial segment was flat for the quarter. Base business levels remained solid, while project business was soft compared to Q1 of last year, particularly in Asia Pacific.

Our pipeline looks good. And although we did see some hesitancy by end customers to pull the trigger on select projects in Q1, we believe the balance of the year will be better.

Process segment had a very strong quarter with double-digit organic growth.

Growth was broad based across product categories and end markets. We leveraged the volume and the good earnings performance and are pleased with the continued operating margin improvement for this segment.

The Contractor segment was flat for the quarter with solid growth in Asia Pacific and EMEA, offset by a decline in the paint store business in North America.

Our decline in North America paint channel was at least partially self-inflicted as new products planned to launch early in the quarter were finally launched near the end of the quarter.

We expect new products to contribute to paint channel sales and earnings performance as we head through the rest of the year.

Home center America sales were up double digits.

In both channels, out-the-door sales were stronger than purchases. Combination of new product launch costs in the quarter, without significant new product revenue, and the unfavorable result in channel mix put pressure on Contractor segment earnings.

Although it was not a good start, we are holding to our target of flat operating margins for the segment for the full year with mid-single-digit top line growth.

To meet this, it will be important to have a better Q2 in Contractor Americas.

A comment on profitability. Between our slide deck and our commentary, I think we've covered the factors that weighed on profitability in Q1. We believe these issues will moderate as we progress through the year. The broader market demand remains stable. New products have launched, and price realization is on track.

Assuming we realize our top line growth forecast, we anticipate incremental margins will normalize as we move through the year.

We plan to stay the course on our long-term investments and won't execute significant spending adjustments unless we see weakness that persists through the second quarter.

Moving on to our outlook. Despite the slow start, we continue to target mid-single-digit organic sales growth on a constant currency basis with growth in all reportable segments and regions for the full year 2019.

Our end markets, project pipelines, new products and improved pricing realization will give us opportunities to have a good year.

The team is working hard to make it happen. Operator, we're ready for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) We'll take our first question from Joe Ritchie from Goldman Sachs.

Joseph Alfred Ritchie - *Goldman Sachs Group Inc., Research Division - VP & Lead Multi-Industry Analyst*

Pat, maybe just kind of starting on growth trends for a second, and then just focusing on industrial, you take a look at the Asia Pac business, down a bit this quarter. I guess, can you parse that out a little bit for us? How much of it was auto centric? What else was happening with the net end market this quarter? And then conversely, obviously, Americas was really strong. And so any color on the Americas will be helpful as well.

Patrick J. McHale - *Graco Inc. - President, CEO & Director*

Sure. I think in both situations with Industrial our numbers can move around a little bit due to the timing of project activity. When you take a look at the underlying base business demand, particularly in our legacy business in Asia Pacific, it looks pretty good. We did have some projects in the first quarter last year that didn't repeat in the first quarter of this year. But overall, I think the demand patterns look okay and our pipeline looks okay, so we expect the balance of the year to be better. And I think similarly in North America, we put up a big number, but we also had some project activity hit in Q1 in North America that might have made that number look a little bit stronger. So there's always going to be a little bit of noise in our Industrial number from quarter-to-quarter. Generally, I wouldn't say Industrial demand across the globe is great, but I would say it's okay. And we think that the year's going to be decent.

Joseph Alfred Ritchie - *Goldman Sachs Group Inc., Research Division - VP & Lead Multi-Industry Analyst*

Okay. Got it. That's helpful. And I guess, maybe just kind of staying on Industrial's for a second. We were a little surprised by the decrementals in that business. And so can you maybe just provide a little bit of color on whether there was any like mix impact in the quarter? Or what really kind of drove like the weaker decrementals this quarter?

Patrick J. McHale - *Graco Inc. - President, CEO & Director*

Yes, I'll let Mark and Caroline weigh in.

Mark W. Sheahan - *Graco Inc. - CFO & Treasurer*

Yes, I mean, for sure, the decrementals were ugly, but we kind of expect that with the business. Incrementals are great in the business. And when sales decline, we just don't stop all of our investing and our initiatives, so we don't have enough variable expenses to bring the profitability in line with the sales decline. And then you combine that with the pressure that we had from currency and a little bit of lower gross margin, and I would say that the decrementals in Industrial are pretty much what we would expect them to be given the volume decline. Probably, a little bit harder in AP as you would expect than in other regions, but overall, kind of what we really expected. Caroline, I don't know if you have anything to add.

Caroline M. Chambers - *Graco Inc. - Executive VP of Information Systems, Corporate Controller & Principal Accounting Officer*

Yes, AP, in particular, we did see a little bit of the effect of the retaliatory tariffs for the business in China.

Operator

We'll take our next question from Deane Dray with RBC Capital Markets.

Deane Michael Dray - *RBC Capital Markets, LLC, Research Division - Analyst*

Can we get a quick postmortem on the Contractor new product launch? Missteps don't happen often, and I'm sure you've addressed the issue. But if you just take us through what happened and what corrective actions were taken.

Patrick J. McHale - *Graco Inc. - President, CEO & Director*

Yes, we had planned to launch our new products early in the quarter and take advantage of the early start to the spring selling season. We did have a couple of quality problems that we discovered as we were going through the final bill. They didn't get out the door, but we did stop production and put engineering on top and make sure that we had good solid fixes in place before we went back and did the launch. It does happen from time to time, but I would say that the magnitude of it here in the first quarter and the timing of it was bigger than usual. And none of us are happy about it, but we're happy that the products are going out the door now and that the quality is solid, and we'll just have to do the best we can to make some hay in the second quarter.

Deane Michael Dray - *RBC Capital Markets, LLC, Research Division - Analyst*

Can you size for us what the impact was, either overtime, additional shipping, anything that became more expensive to do in the quarter?

Patrick J. McHale - *Graco Inc. - President, CEO & Director*

Yes. No, it's pretty impossible to do. The distribution channel is -- knows we have new products coming, and so they're trying to sell out the old and prep for the new. And when the new is not ready, and of course, the sales guys can't run around and push the new to the end customers. So there's no way to put a number on it. But certainly, with our experience in new product in Contractor, we know that late launch in new products is not a good thing.

Deane Michael Dray - *RBC Capital Markets, LLC, Research Division - Analyst*

Got it. And then just switching over to the price increase initiative. You started to see traction on that in March. Can you quantify for us what the effect was? And then also, any -- qualitatively, how much of these prices stuck any pushback? And any comments about your pricing power there would be helpful.

Mark W. Sheahan - *Graco Inc. - CFO & Treasurer*

Yes, I think that normally, this is Mark, we do roll our prices throughout the first quarter. So nothing dramatically different there. As we worked through the quarter, we definitely saw improvement in terms of price cost. I know we don't break that out for you guys, but I feel like as we are sitting here today, that we're in a really good position when it comes to offsetting our cost pressures that we have from commodities and tariffs and other things with the pricing actions that we took. I would say that generally speaking, these are sticky. We don't build in any kind of surcharges or those types of things. We do have a couple of customers that ask us to break out what the impact of things like tariffs were. So we'd expect that if some of that changes, we'll have discussions with them. But no, no automatics in terms of pullbacks in our pricing actions.

Operator

We'll take our next question from Jeffrey Hammond with KeyBanc Capital Markets.

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

So just back on Contractor. Just given the timing of the new product rollouts, do you expect some catch-up or bigger second quarter as a result?

Patrick J. McHale - *Graco Inc. - President, CEO & Director*

I do. And we, definitely, need it. We didn't pull back our full year forecast, and we're off to a slow start. So just do the math on it. It's like a batting average, right? You've got to pick it up if you get behind. And so we definitely expect Q2 to be better, and if it isn't, we're going to have some problems.

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

And what's been the feedback on the new products as they've finally been launched?

Patrick J. McHale - *Graco Inc. - President, CEO & Director*

Yes. It's been good. And we expected it. We have a strong new product launch year. It was just the timing that was bad. So we're touching a fair size of the product line, and we've got some nice benefits for our contractors in there. And given the fact that the overall end market seemed to be good and contractor backlog seems to be good, we think that this is a good environment for us to be pushing those products.

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

Okay. And then just -- I think you were expecting some product disruption around the new facility in the first half of the year. Can you talk about what that impact was in 1Q and what you think the impact is in 2Q and how it's kind of playing out relative to expectations?

Patrick J. McHale - *Graco Inc. - President, CEO & Director*

Yes. We definitely don't expect any product disruption. That would be terrible if that happened, and I hope my manufacturing folks are listening, but we intend to keep our products in stock and give great service to our customers. Really, the issue is that there is going to be some noise in the facility and some extra expense as we do different additions and move pieces around. And I think our belief is, through the first quarter, that the impact was not significant. But as we get into later quarters and we start having to move some equipment around, there may be some incremental expense that it's driven against the Contractor P&L.

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

Okay. And then finally, just -- can you just talk about kind of trend through the quarter? We've heard some people talk about weather disruption or slower start to the year. Just maybe talk about -- and then building momentum into 2Q.

Patrick J. McHale - *Graco Inc. - President, CEO & Director*

Yes. You know we operate all over the globe, and we've got so many different end markets that I don't think there's really any insights that I can give you in terms of trends through the quarter.

Operator

We'll take our next question from Saree Boroditsky with Jefferies.

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

You mentioned some hesitancy on customers' behalf to pull the trigger on Industrial projects. If you just put any color on any particular end market you're seeing that in?

Patrick J. McHale - *Graco Inc. - President, CEO & Director*

Saree, you were breaking up there. Could you repeat that?

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

Sorry. You mentioned some hesitancy on customers to pull the trigger on projects in Industrial. Could you provide any color on any particular end market you're seeing in that?

Patrick J. McHale - *Graco Inc. - President, CEO & Director*

Yes. That was really specific to some projects over in Asia Pacific and, I think, probably a little bit of the uncertainty surrounding what's happening with the back and forth between the U.S. and the Chinese government. But we did have a couple of projects that we would have expected would probably have -- orders would have been placed in Q1, and they weren't. So again, it was not a big deal, but projects can move our business around quarter-to-quarter, and we just wanted to point out that we did see in a few cases some hesitancy there, and it's probably due to the uncertainty.

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

Great. That's helpful. But it looks like you increased your estimates for production and distribution capacity cost for the year. Is there anything -- any additional expansion plans or anything else to highlight there?

Mark W. Sheahan - *Graco Inc. - CFO & Treasurer*

We did. We did increase our capital investment by, I think, $10 million on the building side, if that's what you're referring to, and that was really just a matter of us fine-tuning some of the design aspects of the projects that we're working on. As those designs came together, the costs were a little bit higher than what we were anticipating at the end of last year. But certainly, we're still moving forward with the projects, and they're on good cadence at this point.

Operator

We'll take our next question from Mike Halloran with Robert Baird.

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

So a quick question then. Pat, you've got some moving pieces here from timing and projects, some of the tariffs pulling things down a little bit, the product launches. When you think about the core demand or what your customers are saying across the 3 segments, across the regions, how much has really changed from your -- in your thought process from a few months back when you first gave -- laid that guidance out? And any specific changes you would mention?

Patrick J. McHale - *Graco Inc. - President, CEO & Director*

Yes. I would say really not much. The only thing that we did and reflected in our, I guess we call it our bubble chart is we did dial back our expectation for the full year for Asia Pacific a little bit just because they dug themselves such a big hole in the first quarter. We do believe that the rest of the year is going to be better, and we believe overall, we're still going to be in that mid-single-digit range. Certainly, it's more fun to get off to a good start and not have to dig your way out of a hole, and we didn't. But we're not that far out of the game. And again, looking at our project activity, our new product launches and a reasonably decent environment for most of our end markets, we still think that we've good opportunities in front of us to have a good year, and that's what we're going to try to do.

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

Anything different on the capital deployment side for you? Obviously, any commentary on market valuations opportunity set for acquisitions or what your appetite for share buyback looks like?

Patrick J. McHale - *Graco Inc. - President, CEO & Director*

No. Everything is expensive right now. So we're going to stick to our normal playbook, and we're going to try to make good decisions and buy things when we can get a good return for our shareholders.

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

Anything on buybacks?

Mark W. Sheahan - *Graco Inc. - CFO & Treasurer*

We didn't do any in Q1, and I think we said we'd be opportunistic here in 2019. Obviously, we've got a balance sheet that can support some debt, so we'll see how the year plays out, and we'll take an opportunistic approach.

Operator

We'll take our next question from Matt Summerville with D.A. Davidson & Co.

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

Mark, you had commented on pricing earlier. Maybe, just a little bit more help there. Are you able to sort of quantify maybe the difference, if you will, in price realization you're anticipating in 2019 over what you've realized in 2018?

Mark W. Sheahan - *Graco Inc. - CFO & Treasurer*

Yes, I think we're still kind of in that same 1.5% to 2% overall price realization, Matt, for the full year.

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

Got it. And then just a follow-up, maybe, just specific to the automotive market. Pat, can you give a little bit of maybe regional color on what you're seeing specifically in auto in the context of the production environment we're in but also what you're seeing on the new platform side as far as launches, redesigns kind of driving that piece of the business as well, project funnel there, et cetera? Just sort of a deeper dive on auto, if you will?

Patrick J. McHale - *Graco Inc. - President, CEO & Director*

Yes, so generally across the board, automotive production is down a little bit from the peak. And that business, for us, on the legacy side is about 40% parts and accessories. So being down a little bit off the peak, it's still a decent environment. They're still using Graco equipment, and they're still buying spares. In terms of project activity, the new plant builds and the capacity expansion has primarily been coming out of Asia Pacific for the last number of years. There are projects and retrofit opportunities in both Europe and North America that we chase and that we continue to chase. I would say that it's not a depressed environment in terms of new platforms or new upgrades, but I wouldn't call it robust either. I think the word that we're using is it's stable or it's okay, and there are opportunities for us to take share. We also have new products that we've targeted at automotive here last 2 or 3 years that we still have opportunities to do conversions on. So -- and we continue to go after the market. I don't think it's going to -- not going to make or break us this year. That's my view.

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

And then just back to Contractor. Would you say at this point as we're now at the end of April, you're fully launched for the season in Contractor in both propane and home center? Or are there incremental launches that we should sort of be paying attention to yet to come here in the second quarter?

Patrick J. McHale - *Graco Inc. - President, CEO & Director*

No, I think we've got the majority of the products launched that are going to make a difference, and we're ready to sell.

Operator

(Operator Instructions) We'll take our next question from Walt Liptak with Seaport Global Securities.

Walter Scott Liptak - *Seaport Global Securities LLC, Research Division - MD & Senior Industrials Analyst*

I don't want to beat the dead horse on Contractor, but here we go. Want to ask about the timing. You guys said you were disappointed on the late start, but it seems like the housing sector is kind of having a late start to the year, and Jeff brought it up about the weather. Does it matter -- I mean, do you get sort of a -- and I can call it a pass, but do you get some kind of a benefit from being late? But the whole market is late this year so maybe uptick could be a lot stronger in the second quarter, and you're going to be on a tough comp in the second quarter, too. So I guess, the question is: Your thoughts on the overall health of the U.S. housing sector and how that flows through the Contractor? And then just the buying habits of -- with the late start to the year?

Patrick J. McHale - *Graco Inc. - President, CEO & Director*

So again, what we see is we see that the contractors have jobs. And when the contractors have jobs and there's a backlog, then generally they're positive in terms of buying equipment. And so we're going to be in the key season here, the next 2, 3 months, and we're going to be out doing our shows and launching our new products. We think it's a good environment for a contractor to buy paint spray equipment, and we intend to try to capitalize on that.

Walter Scott Liptak - *Seaport Global Securities LLC, Research Division - MD & Senior Industrials Analyst*

Okay. But did you miss the market? Like did they use that, the downtime in the first quarter, to buy new equipment, and then they're going with equipment in the second quarter already? Or is this -- or are there different buying patterns this year?

Patrick J. McHale - *Graco Inc. - President, CEO & Director*

No, I don't think we missed the market, but I mean, any time that you're late launching a product, you're going to get some of the sales later, but you're probably going to lose some, too. You're not necessarily going to get it all. There may have been somebody that would have bought a piece of equipment in February, and we didn't have it available, and they did something else. So I anticipate that some of the demand will get pushed, and some of it's just amiss.

Walter Scott Liptak - *Seaport Global Securities LLC, Research Division - MD & Senior Industrials Analyst*

Okay. Great. And then the EU being strong. I wonder if you could just review, again. Which segments were strong in Europe? And specifically, which end markets?

Patrick J. McHale - *Graco Inc. - President, CEO & Director*

Yes. So I wouldn't say that there's anything that's smoking hot over there. If you take a look at our results, they were okay, and they were supportive of our full year outlook. And that really held pretty well across the -- again, x currency, it held pretty well across our business units, I think, with the Industrial a little bit lighter and the Process business a little bit better. But in general, again, I would say that the overall environment in EMEA is stable, and we just need to do our job.

Operator

At this time, there are no further questions in the queue. I will now turn the conference over to Pat McHale.

Patrick J. McHale - *Graco Inc. - President, CEO & Director*

All right. Well, thanks, everybody, for your time this morning, and hopefully, we're going to have a little bit more fun on the second quarter call. All right, catch you end of July.

Operator

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