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GGG - Q1 2014 Graco Earnings Conference Call

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OVERVIEW:

GGG reported 1Q14 sales of \$290m and net income of \$51m or \$0.81 per diluted share.



CORPORATE PARTICIPANTS

Caroline Chambers *Graco Inc. - VP, Corporate Controller and Information Systems*

Pat McHale *Graco Inc. - President, CEO*

Jim Graner *Graco Inc. - CFO*

CONFERENCE CALL PARTICIPANTS

Matt Summerville *KeyBanc Capital Markets - Analyst*

Walter Liptak *Global Hunter Securities LLC - Analyst*

Liam Burke *Janney Montgomery Scott - Analyst*

Jim Krapfel *Morningstar - Analyst*

PRESENTATION

Operator

Good morning and welcome to the first-quarter 2014 conference call for Graco Inc. If you wish to access the replay of this call, you may do so by dialing 1-800-406-7324 within the United States and Canada. The dial-in number for international callers is 303-590-3030. The conference ID number is 4678040. The replay will be available through April 27, 2014.

Graco has additional information available in a PowerPoint slide presentation which is available as part of the webcast player. At the request of the company, we will open the conference up for questions and answers after the opening remarks from management.

During this call, various remarks may be made by management about their expectations, plans and prospects for the future. These remarks constitute forward-looking statements for the purpose of the Safe Harbor provisions of the Private Securities Litigation Reform Act. Actual results may differ materially from those indicated as a result of various risk factors, including those identified in Item 1-A of the company's 2013 annual report on Form 10-K, and in Item 1-A 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 Miss Caroline Chambers, Vice President, Controller and Information Systems. Please go ahead ma'am.

Caroline Chambers - *Graco Inc. - VP, Corporate Controller and Information Systems*

Good morning everyone. I'll provide a brief top-level summary of our quarter and then we will turn the call over to Pat for additional discussion. Our conference call slides are on our website and provide additional information on our quarter.

Sales were \$290 million, an increase of 8% from the prior year. Sales from the recently acquired EcoQuip and QED businesses were \$7 million, or 3 percentage points of our overall growth. Regionally, sales in the Americas grew by 15%, sales in EMEA increased by 7% or 3% at consistent translation rate, and sales in Asia-Pacific were down 7%.

Gross profit margins as a percent of sales were 55% for the quarter as compared to 56% in the prior year. Acquisition-related inventory charges, lower margins from acquired operations, and change in product mix contributed to the lower margin rate.

Operating expenses included the effect of the acquired businesses and \$1 million for incremental investment in regional and product growth initiatives. Operating expenses also included \$1 million of acquisition and divestiture expenses in 2014. These expenses were not significant in the first quarter last year.



Other income includes dividends from the Liquid Finishing businesses of \$4 million for the quarter, the same as the first quarter 2013. The Liquid Finishing businesses are accounted for as a cost investment since we cannot control the operations of Liquid Finishing under the terms of the hold separate order from the Federal Trade Commission. Additional discussion of the Liquid Finishing businesses is included in our 2013 Form 10-K and in our first-quarter 2014 Form 10-Q.

The effective tax rate for the quarter was 31%, 4 percentage points higher than the prior year. Last year's rate included the impact of the federal R&D tax credit that was renewed in the first quarter of 2013 and was retroactive to the beginning of 2012. The R&D tax credit has not been renewed for 2014.

Net income totaled \$51 million or \$0.81 per diluted share. Net cash provided by operating activities was \$28 million for the quarter with growth in working capital in line with business volume and consistent with prior quarterly trends. Days of sales outstanding for Accounts Receivable remain consistent.

Capital expenditures were \$7 million. Other significant uses of cash this quarter included the acquisition of QED for \$65 million, dividends of \$17 million, and share repurchases of \$48 million.

A couple of other discussion points. We expect the dividends from Liquid Finishing to be \$11 million in the second quarter, the same as the second quarter in 2013.

The tax rate for the second quarter is expected to be approximately 28% to 29%. The full-year tax rate is expected to be approximately 29% to 30% excluding any effect from an eventual sale of the Liquid Finishing investment. This estimate also assumes that the federal R&D tax credit is not reinstated for 2014.

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

Pat McHale - Graco Inc. - President, CEO

Thanks Caroline. Good morning everyone. Our outlook remains generally in line with the 2014 view that we communicated in late January. The macro environment worldwide remained inconsistent but had slightly better growth rates than we saw in 2013. We continue to expect full-year organic growth in each of our regions and in each of our reportable segments.

My comments today are based on consistent exchange rates. I'll start with Contractor.

As expected, our Contractor business posted double-digit growth in the Americas in Q1. Sales growth was relatively flat internationally for the quarter, but I do expect Contractor sales in both EMEA and Asia-Pacific to post growth for the full year.

In the Americas, out-the-door sales were solid in Q1 with double-digit increases in both the paint store and the home center channels. We added another home center partner in the Americas in Q1, a household name in the Midwest with about 300 stores. The addition of this partner helped offset a difficult sales comp from the first quarter of 2013 where we had a large sale of equipment to a rental channel partner that did not recur in 2014.

On our last investor call, I discussed the significant renewal of our line of professional airless paint sprayers which drove a spending increase in the fourth quarter of 2013. The products did successfully launch very late in the first quarter, and the initial reaction from our channel partners and from painting contractors has been positive.

Incremental profitability on Contractor revenue growth in the first quarter was an unimpressive 26%, as factory spending was up on capital equipment projects and a large new product launch. Mix was also a factor. Within our paint store channel, we saw faster growth in lower margin categories as our redesigned larger units were not ready to ship until later in March.

The fundamentals of the business are sound, and I expect flow-through profit for this segment should revert back to the norm as the year progresses.

Moving onto Industrial, Industrial Americas outperformed our expectations with 10% organic growth. Demand was relatively broad-based in the quarter. Despite the strong start, we do expect the Industrial Americas growth rate to be in the mid-single digits for the remaining three quarters of 2014. In EMEA Industrial, we saw mid-single-digit growth, which was driven entirely by the developed countries of Western Europe. The emerging markets of the East were flat overall with significant variation between countries and product lines. As anticipated, Industrial sales in Asia-Pacific declined in the quarter off difficult comps from Q1 of last year. Worldwide Industrial segment operating earnings were flat year-over-year on sales growth of \$11 million.

A few distinct factors played into the lack of flow-through profitability. The acquired businesses at QED and EcoQuip contributed \$7 million of the increase with zero profit. For our Legacy business, decremental margins on a significant reduction in Asia-Pacific revenue were larger than the incremental gains on the increase in EMEA, causing a drag for the quarter.

Investments we are making in growth initiatives added about \$1 million to quarterly expenses, including our spending on South and Central America expansion, investments in our process business, and incremental commercial resources to pursue our hot melt packaging initiative. We are confident that these investments will produce results but there will be some lag.

The underlying fundamentals of our Industrial business remain intact although the regional and product investments may be a slight drag in the near term. We will continue to look for and invest in long-term growth initiatives for Industrial.

Lubrication posted solid mid-single-digit growth in the Americas in Q1 with growth in both vehicle services and industrial lubrication. EMEA was relatively flat, and Asia-Pacific contributed a nice double-digit increase. Strong margin performance and good cost controls in our worldwide lubrication segment resulted in very nice flow-through profitability. For the full year, I expect we will see operating margin in the low 20s% on a single digit worldwide growth rate.

With regard to the hold separate business, they posted another quarter of growth on the top and the bottom line. We continue to dialogue with the SEC but we remain uncertain as to the timing of the final decision and order. In the meantime, we are the beneficiary of the cash flow of the business via dividends. Those are expected to have an identical cadence and amount with what occurred in 2013 and our plan is for \$11 million in Q2.

Before turning it over for questions, I'd like to go through our outlook one more time. In the Americas, we are expecting Industrial organic growth in the mid-single digits for the remaining three quarters of the year. We expect our Contractor Americas business will have a full-year growth rate in the low double digits, and the Lubrication Americas business will have full-year growth in the single digits. All in, the Americas are expected to grow in the mid-to high single digits for the full year 2014.

We are continuing to expect our overall EMEA region to grow organically in the lower to mid single digits for the full year 2014, but ongoing tensions in emerging markets are a risk factor. We believe Asia-Pacific will dig out of the Q1 hole and can post low single-digit growth for the full year.

Overall, we believe Graco can post consolidated growth in each quarter of 2014 and anticipate ending the year with mid-single-digit organic growth. Our acquired businesses of QED and EcoQuip should add just under 3 percentage points to Graco's worldwide growth rate for the year. Most of the sales of these businesses are in the Americas, and all of their sales are in the Industrial segment.

Overall, we've started the year relatively in line with our outlook and we expect another record year in 2014.

Operator, we are ready for questions.



QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Matt Summerville, KeyBanc.

Matt Summerville - KeyBanc Capital Markets - Analyst

Good morning. Pat, can you give a little more granularity in terms of the magnitude of volatility you're seeing in China on either a week-to-week or month-to-month basis, what end markets there seem to be working, which ones don't?

Pat McHale - Graco Inc. - President, CEO

Our overall incoming order rate in China has been fairly flat, and so I don't think there's really any particular story to be seen as you kind of look within our product categories. From quarter-to-quarter and product line to product line, we see things moving up and down and we just don't see that sort of kind of continued upward push that we had seen 1 1/2 or 2 years ago across all the product categories. So I think they are just kind of struggling in general but I can't point at anything in particular.

Matt Summerville - KeyBanc Capital Markets - Analyst

And then with respect to the new home center customer, can you maybe quantify what the initial sell-in added to your Contractor results in the quarter, and are you fully stocked there at this point?

Jim Graner - Graco Inc. - CFO

This is Jim. So it's about between \$1 million and \$2 million in the first quarter. We expect a little bit more in the second quarter, but then it should be fully stocked.

Matt Summerville - KeyBanc Capital Markets - Analyst

Great. Thanks a lot.

Operator

(Operator Instructions). Walter Liptak, Global Hunter Securities.

Walter Liptak - Global Hunter Securities LLC - Analyst

Thanks. Good morning guys. Walter Liptak. I Wanted to ask about I think your comments on China are a little bit better than they were at the conference call last quarter. And I guess as you look at some of your end markets, I know you commented a little bit about this on the last question. But do you think we will get back to some of the growth rates that you had seen in the past, or is this a market now that's matured and when it recovers we're going to see more mature growth like we see in the rest of the world?



Pat McHale - Graco Inc. - President, CEO

No, obviously their economy has gotten a lot bigger. And as it gets larger, of course putting up the same sort of percentage increases becomes more difficult.

My long-term view is that there is a long way to go, and that what we are going to see is we are going to see a return a nice growth rates in China again, but I think, for a while there, everybody got caught up in it's going to be great double-digit shoot for the moon forever. And my view is it's not going to work that way, that it is going to be a bit more of a choppy ride. So I think we're going to have periods where things are a little difficult, but I really still expect it to be a good long-term story. We were over there here just a month ago, and there is a lot going on and there are still a lot of people that are moving themselves up towards the middle class. And I think the story there is going to be positive if you've got the patience to wait for it.

Walter Liptak - Global Hunter Securities LLC - Analyst

Okay. Did you exit the quarter stronger than the way you entered it?

Jim Graner - Graco Inc. - CFO

Our orders for the first quarter of 2014 were just slightly under our first quarter of 2013, so positive on order versus our decline but not significant for the second quarter.

Pat McHale - Graco Inc. - President, CEO

And that's specific to China, correct?

Jim Graner - Graco Inc. - CFO

Correct.

Walter Liptak - Global Hunter Securities LLC - Analyst

And then in the US, with some of the housing numbers looking a little bit weaker here this year, and I think you alluded to some of this in your comments in the press release. I wonder if you'd talk about what you're hearing from the contractors we have as well as new construction, and how that's impacting your outlook for the year?

Pat McHale - Graco Inc. - President, CEO

We look at all the same data everybody else looks at. My personal opinion is that the housing market is going to be fine this year and that we're going to finish somewhere between that \$1 million and \$1.1 million start level. I think there's -- interest rates are still pretty low. Pricing has firmed up in most of the markets. In fact, some markets, we're seeing some pretty significant increases in pricing. Inventory seemed to be low. And the current build rate I think is just not enough for I'll say a normal, stable US economic environment. So I think we are still on the way back and I don't get too concerned over the little bit of noise we've seen here in some of the recent numbers.

Walter Liptak - *Global Hunter Securities LLC - Analyst*

Okay. And then I guess the last one, with respect to kind of some of the higher spending levels this quarter, are those going -- you still have some recurring costs for incremental spending in the second quarter and in the back half. They're lower, or is it in the back half you start getting some benefits of the spending?

Jim Graner - *Graco Inc. - CFO*

This is Jim. Our spend should be consistent with those initiatives for all four quarters of this year. It's part of our base now, and we like those efforts, we like the opportunities that those markets provide.

Walter Liptak - *Global Hunter Securities LLC - Analyst*

Okay, great. Okay, thanks very much guys.

Operator

(Operator Instructions). Matt Summerville, KeyBanc.

Matt Summerville - *KeyBanc Capital Markets - Analyst*

Just a couple more quick ones on the Contractor business. This next-generation airless line that you launched late in the first quarter, was that material to revenue, number one?

And then number two, if you look at this current generation of sprayers relative to the prior generation, what would you say is the ASP differential?

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

I'll answer the first part, that it wasn't significant in the first quarter. We launched it pretty late. And we may have gotten a little bit of revenue from it at the very end of the first quarter but we probably also had people that weren't buying in anticipation of it. So I really think it's going to show it stripes here in the second quarter.

I'm not sure on the ASP. It might be a little bit higher. I don't think it's dramatically different.

Jim Graner - *Graco Inc. - CFO*

I think our expectations all-in, as these product launches, our gross margins should improve slightly versus the same products a year ago. Pat mentioned earlier that our profitability was disappointing, incremental profitability was disappointing at 26% in the first quarter. Part of that has to do with the fact that we think a number of people were waiting for these larger units to come out. So once again, we find ourselves with a bigger percentage increase in smaller lower price units versus the higher performing, higher-priced units.

Matt Summerville - *KeyBanc Capital Markets - Analyst*

So with this Q2 sort of having the full impact of this new line being available, with -- I don't know if you thought there was maybe some purchases that got deferred due to weather, if that was an impact. Is the second quarter going to be more seasonal than we would normally expect because of those factors?

Jim Graner - Graco Inc. - CFO

We are not sure. Again, we do think that there is some pent-up demand for these larger units that will impact the second quarter.

Matt Summerville - KeyBanc Capital Markets - Analyst

Okay. That's all I've got. Thanks.

Operator

Liam Burke, Janney Capital Markets.

Liam Burke - Janney Montgomery Scott - Analyst

Thank you. Good morning, Pat. Pat, you gave some color on the Industrial side in the markets. Can you give us a little more detail on what products did particularly well during the quarter?

Pat McHale - Graco Inc. - President, CEO

So when you look at Industrial strength, a lot of it was coming out of the Americas. And we actually saw demand across most of our product platforms being pretty decent. It wasn't like we had one particular product category that spiked. I will note that our spray foam business had a good first quarter, and so that continues to be a nice this is for Graco. But generally demand was pretty broad-based.

And again, when you look at it by product category, and you look at it in Europe and Asia, there's not any particular story. I think different product lines had different rates of growth or decline in different countries. And I think it more reflective of the overall growth in the marketplace or lack thereof than anything happening in any particular industry.

Liam Burke - Janney Montgomery Scott - Analyst

Okay. Thank you. And would you anticipate -- it looks like nonresidential construction is beginning to show some signs of life. Do you think that's going to be any kind of significant help to the Contractor business in 2014?

Pat McHale - Graco Inc. - President, CEO

There's been some optimism about that kicking in here. And when it does really kick in, that's going to be a plus for us, and so we are looking forward to that. Certainly they tend to buy the larger pieces of equipment and we haven't really seen a robust non-res market since it kind of started falling apart back in that kind of 2007, early 2008 timeframe. So we welcome that, and I agree with you. The data that's coming out tends to indicate that maybe that's going to start to kick in. But we've kind of been there for a few quarters where we've talked about non-res coming back. And although the data is up a little bit, we haven't seen it really kick in yet. So, I'm going to take a wait-and-see attitude, but certainly it will help our Contractor business when it becomes real.

Liam Burke - Janney Montgomery Scott - Analyst

Great. Thank you Pat.



Operator

Jim Krapfel, Morningstar.

Jim Krapfel - *Morningstar - Analyst*

Good morning guys. So one of your key strategic growth initiatives is the conversion of end-users from manual painting techniques to spray equipment. So I'm just curious to hear the recent efforts there, and how much traction it's getting.

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

In terms of level of activity, we are very active on that front, and we are actually expanding that initiative down into South and Central America. We're putting more feet on the ground.

I would say, from a traction standpoint, the last few quarters have been disappointing. We have lots of opportunity in places like China. We took a little bit of a road trip from our corporate headquarters out to one of our factories there, and I couldn't count the number of buildings that were going up and the number of cranes that were going up, and yet the penetration rate on spray equipment is very low. So, the opportunity continues to be large. I'm a little bit disappointed on our ability to capture that in some of those markets over the last few months, but we believe it's still the right long-term plan, that it's going to provide good benefits for us.

Jim Krapfel - *Morningstar - Analyst*

What is the overall penetration rate, say, in China?

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

My estimation in China is it's probably in that 10% sort of a range.

Jim Krapfel - *Morningstar - Analyst*

Got you. All right. Thanks guys.

Operator

(Operator Instructions). If there are no additional questions, I will now turn the conference over to Mr. Pat McHale. Please go ahead sir.

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

All right. Well, thanks for your participation in the call today. And we're going to work hard and we look forward to having a good year. Thanks.

Operator

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

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