GRACO, INC., #4478419
GRACO, INC. THIRD QUARTER 2011
EARNINGS CONFERENCE CALL
October 27, 2011, 11:00 AM ET
Chairperson: Caroline Chambers (Mgmt.)

Operator: Good morning and welcome to the Third Quarter 2011 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 4478419. The replay will be available throughout October 30th, 2011. 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 question 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 risks factors, including those identified in Item 1A of, and Exhibit 99 to, the Company's 2010 Annual Report on Form 10-K, and in Item 1A of the Company's most recent Quarterly Report on Form 10-Q. These reports are available on the Company's website at www.graco.com, and the SEC's website at www.sec.gov.

Forward-looking statements reflect management's current views and speak only as of the time they are made. The Company undertakes no obligation to update these statements in light of new information or future events. Throughout today's presentation, all participants will be in a listen-only mode. If any participant has difficulty during the presentation, please press the star, followed by the zero on your telephone for operator assistance. I will now turn the conference over to Caroline Chambers, Vice President and Controller. Please go ahead.

Caroline Chambers: Good morning everyone. I am here this morning with Pat McHale, Jim Graner and Christian Rothe. I will provide some comments on the financial highlights of our third quarter, and Pat will follow with additional comments. Slides are available to accompany this call and can be accessed on our website. The slides include information about our consolidated financial results, and each of the segments. After our opening comments, we will open up the call for your questions.

Sales increased by 20% for the quarter, including four percentage points for currency translation, with strong growth in all segments and regions. Changes in currency translation rates also increased net earnings by 3 million for the quarter. Additional information about effective currency translation on sales for the segments and regions, as well as sales by currency, are included on page 5 in the slides that accompany this webcast.

Gross profit margins were 56% for the quarter, up half a percentage point from the prior year. Overall, the favorable effects of higher volume, currency translation, and selling price increases were partially offset by higher material costs. However, within our lubrication segment, production costs and less favorable factory performance offset the higher volume.

Operating expenses for the quarter increased by 8 million, including 3 million of transaction costs related to the pending acquisition of ITW Finishing businesses and 2 million related to currency translation. Selling, marketing and distribution expenses were 3 million higher in the quarter. Interest expense was 3 million for the quarter, and the effective tax rate for the quarter was 32%, compared to 28% for the quarter last year. The prior year included favorable effects of tax law rulings and expiring statutes of limitation.

Year-to-date cash flow from operations was 109 million, compared to 62 million last year. Inventories and accounts receivable leveled-off in the third quarter, after increases in the first half, related to increased business volume. Capital expenditures are 17 million year-to-date, and we have paid dividends of 38 million year-to-date. We also purchased 38 million of Company stock, representing 1,059,000 shares at an average price of $36.23. 35 million of the total share repurchases settled in the quarter, and 3 million was in accounts payable at quarter end. The second 150 million of the previously announced 300 million of long-term debt was drawn in July, in accordance with our credit agreement. Cash is held in deposit accounts and money market funds.

A few other items to note. We expect to see material cost pressures moderate slightly in the fourth quarter, as compared to the third quarter. Factory production levels are expected to be in line with sales growth, and slightly lower that the fourth quarter last year, which included substantial ramp-up in factory volume. Expenses associated with pending acquisitions are expected to be 3 million in the fourth quarter. We expect that expenses in total will be in the range of 20 million for the transaction. Interest expense for the fourth quarter is anticipated to be 4 million, and based on the expected profitability of our international subsidiaries and the current exchange environment, we expect the annualized tax rate to be approximately 33%.

With that, I will turn the call over to Pat McHale.

Patrick McHale: Good morning, and despite all the negative news, we had another strong quarter, with double-digit revenue growth in every region and segment. This is our seventh consecutive quarter of double-digit revenue and earnings growth. In this quarter, we posted the highest revenue for any third quarter in the Company's history. For the quarter, currency was a tailwind of approximately $3 million on net earnings. However, ITW transaction costs, interest on borrowings that will be used to fund the transaction, and the normalization of our Q3 tax rate compared to last year were a $5 million headwind. Heading these out, I am pleased with the solid incremental net earnings margins for the quarter. As you saw from our prepared slides, material costs remained a headwind in the quarter. We're expecting that to moderate slightly in Q4, based upon changes in commodity cost surcharges.

I'll spend a few minutes talking through each of the divisions and regions, starting with the contractor segment. With worldwide segment growth of 11%, the division performed well during well during the quarter, especially given the weak conditions—ongoing weak conditions in the U.S. and European construction markets. North America pink channel is down 2% for the quarter, primarily due to the store load for handhelds that occurred in Q3 of last year. Without handhelds, our pink channel business in North America was up 23%. Channel inventory of handheld product has normalized, and we expect that Q4 handheld sales in North America pink will meet or exceed 2010 Q4 levels.

The home center business in North America was up strong double-digits. In Europe, our contractor business was down 9%, versus last year's third quarter at consistent exchange rate. Comparisons for 2010 include about 4 million of handheld load in Europe in Q3. There was also an additional 4 million in Q4. Excluding the handheld product, base business in contractor Europe was up double digits in Q3. Our contractor business in Asia and Latin America continues to perform well, with solid double-digit growth in those markets. Based upon feedback from the field, we are anticipating a soft Q4 in our contractor segment. We expect good growth to continue in the developing markets, but in North America and Europe, we anticipate that our channel partners will be cautious with inventory levels as we move into the winter season. We continue to invest in new products, continue to expand our commercial resources, and our channel in developing markets, and user conversion remains a priority around the world in areas where equipment penetration is low.

Moving on the industrial segment. We had another quarter of good growth in the industrial segment, with strength across geographies and product lines. In fact, we hit peak third quarter revenues in industrial this quarter. This was achieved despite both North America and Europe revenues in this segment below peak. It's a great example of the return that we're getting, strategic initiatives to drive growth in the developing markets. Gross and operating margins remain solid, and we continue to invest for long-term growth. We've been monitoring income and order rates closely and continue to see growth versus the prior year. Our outlook for this segment remains positive.

Moving to the lubrication segment. The lube segment continues to perform well, with double-digit growth across regions and product lines. In our historical vehicle services business in North America, we see good investment activity in the service facilities. Our industrial lubrication initiative continues to be in traction. We also see strong growth in Europe and Asia. Similar to our industrial segment, the investments we are making in people and products continue to pay off. The segment is on track to deliver mid to high teen operating margins as expected for 2011, and the outlook for operating margins for 2012 would be 20%, based upon revenue growth and continued factory performance improvement. Our outlook for this segment also remains positive.

Moving on to Europe. During the quarter, Europe continued to show revenue gains at double-digit increases compared to last year, driven by strong performance in our industrial and lubrication segments. Detailing the region a little further, developing economies in Eastern Europe, the Middle East and Africa grew 31% at constant exchange rate. Western Europe was essentially flat, if you include the 2010—excuse me, the 2010 handheld sales. Excluding that comparison point, total sales in Western Europe were up double digits.

Moving on to Asia. Asia continues its trend of great performance with another strong quarter. We had double-digit increases in both developed and developing countries, and across most product categories. In 2010, Asia Pacific significantly exceeded our pre-recession peak, so our 2011 growth is particularly good, given that there's no rebound in these growth rates. We've invested heavily in people and channels during the past few years, and these investments are paying off. There continue to be great Graco opportunities in this region, and we'll be adding more people throughout 2011 and 2012.

During the second quarter, we opened a new Asia Pacific headquarters in Shanghai. This facility includes product demonstration and training capabilities. Over the summer, we've already trained more than 500 employees, material suppliers and distributors at this facility. We anticipate heavy utilization of this capability in the coming years, and expect it will contribute substantially to our efforts to capture share in this important market.

A few closing comments. Again, despite the negative news cycle in the last 10 or 12 weeks, we continue to see solid incoming orders. We do have a short-cycle business, and we'll continue to monitor order trends closely, particularly in Western Europe, where we have the most short-term concern. While we do expect a soft Q4 for the contractor segment, we expect lubrication and industrial will continue to perform well. I do remind you that Graco had a 53-week fiscal year in 2010 and only 52 weeks in 2011. Last year's Q4 had the benefit of the extra week, and I suggest you take this into account while making your Q4 revenue estimates. That being said, we expect full-year revenues for 2011 to be a Company record. Our growth strategies remain sound and are performing well. New products are well received, and our product pipeline is robust. Our teams in Europe and Asia are growing, along with our channel and the capabilities of Graco and distributor personnel. This bodes well for 2012 and beyond.

This concludes my prepared remarks. I now ask the operator to open a session of Q&A.

Mr. Operator, please open the session to Q&A.

Operator: Thank you. The question and answer session will begin at this time. If any participant would like to ask a question, please press the star, followed by the one on your telephone. If you wish to cancel this request, please press the star, followed by the two. Your questions will be polled in the order they are received and there will be a short pause while participants register for a question.

Thank you. The first question comes from Charlie Brady from BMO Capital Markets. Please go ahead with your question.

Charlie Brady: Thanks, good morning guys.

Patrick McHale: Good morning, Charlie.

Charlie Brady: Hey, just with regard to the comment on contractor softness, obviously, Q4 is seasonally softer, but it sounds as though you're expecting something a little bit more than normal seasonality, and even, maybe, more than the fact that you're short a week this year. Is that correct?

James Graner: Well, we're a little concerned as to what the headline news is going to do with regards to the inventory stocking levels at our major channel partners. Our out-the-door sales information that we've received so far in October is good, so we're not seeing any decline in (inaudible) demand, but just thought we should put—share our concerns about headline impact on potential stocking levels.

Charlie Brady: Okay, and then the commentary on the home center channel being up, I guess, double-digit. I mean, does that—does that kind of tie into—do you think you're going to see the frontloading of that in Q3, that impacts the Q4, or is there something else driving kind of the strength of the home center channel?

Patrick McHale: No, again, we believe that the out-the-door sales—or the data we receive from our channel partners show that the out-the-door sales are strong as well.

Charlie Brady: Okay, can you give any kind of commentary around what kind of incremental margins you're looking for in Q4 and into 2012?

Patrick McHale: Is that for the total Company, Charlie, or just with respect to contractor?

Charlie Brady: Well, actually, both.

Patrick McHale: So on contractor, you know, we're seeing a continuation of the shift in the mix of the higher performing units, those that carry higher prices and higher margins, so that trend that we experienced in, I'll call it the last three quarters, continues, so we're expecting a pickup in operating profits in the contractor segment, both for the fourth quarter and for next year. With respect to the Company, you know, we've got some price increases that will be effective in January and February, so we expect that that will more than offset the material costs, pressures we've experienced to date, and those that we're expecting, and we're expecting a relatively positive top line growth. So, we should see small incremental margins for this whole Company as well.

Charlie Brady: Okay, I just want to clarify a point. So on contractor, you're talking about improving margins in Q4. Are you talking about incrementally, or an absolute basis, despite the sales being softer?

Patrick McHale: Well, sales being soft, I would say, rather than softer, so yes, we're seeing both of those, incremental and absolute margin improvement in that segment.

Charlie Brady: Okay, thanks.

Operator: Thank you. The next question comes from Terry Darling from Goldman Sachs. Please go ahead with your question.

Terry Darling: Thanks, good morning.

Patrick McHale: Good morning, Terry.

Speaker: Good morning.

Terry Darling: Hey, Pat, I wondered if you might talk a little bit about how you're thinking about growth rates in Asia looking forward. You know, there's obviously a lot of signs of slowdown going on there, yet, you're working off of a small base, you've got a lot of new product going in there, you're building out your channel investments. You know, 2012 versus 2011, do you see any degradation there at all, or do you think the growth investments can continue to sustain these very nice growth rates you're seeing?

Patrick McHale: Well, my view is that the—with the opportunity that we're going to have due to the economies in those regions and whether they're a little—a couple of points less or a couple of points more, plus all the investments that Graco is making and will continue to make, that we ought to see double-digit revenue growth for an extended period of time in Asia, and whether going to match the 2011 numbers or not, I don't know, but I am planning for double-digit revenue growth in Asia over the course of the next few years.

Terry Darling: And, you know, I think you're on pace for something like, you know, 40%—this 35% or 40% this year—double-digit gives you a lot of cushion in that comment. Can you—can you provide a little bit more color, maybe, just on the level of investment or the level of growth in your sales force, maybe help us this year on this 40%—35, 40%—how much is, kind of, same store sales growth versus, you know, the incremental investments that you've made?

Patrick McHale: I wouldn't be baking a 40% ongoing growth rate into our Asia Pacific numbers, but no I'm not going to help you get fine with 2012 growth rates in Asia Pacific. I will tell you that, you know, since about 2007, that business has doubled. During that time period, from at least a commercial resource standpoint, we've probably been close to doubling our commercial resources in that area, as well. We may add in the range of 50, from a Graco headcount perspective kind of number, next year, which would be probably consistent with what were actually achieved in the last couple of years, and we typically will add several hundred new outlets on an annual basis and I don't see that trajectory really declining either.

Terry Darling: Okay, and then, you know, Pat, on growth for the industrial segment, despite the shift in the comps, the growth remained very strong there on a year-over-year basis, and your comments suggest you're expecting similar growth rates, I think I heard you say, for the fourth quarter. Maybe you could talk about what your—what your thought process is for 2012 there, and maybe parse for us again the underlying market versus the outgrowth in the Graco self-determined, you know, drivers there relative to the investments that you've been making.

Patrick McHale: Are we talking about industrial Asia, is that what you're talking about?

Terry Darling: Yes, industrial broadly. Now, obviously, we're inclusive of Asia in that context. Has it shifted from geography across the Company or just industrial?

Patrick McHale: Yes, you know we're still below peak in North America and Europe, so there's still, I'll say, a little bit of rebound left to be had there. Of course, the last three months, it seems like the world's been trying to scare itself into some sort of a recession, but thankfully, we're not seeing that in our industrial numbers. We ought to grow more than GDP or industrial production due to several factors. We're going to get a little bit of price on an annual basis. Certainly, we invest more on new products than any of our competition by a factor of two to three times as much, and our new products have been well received. We still have the opportunity grow a channel and specialize, particularly in the developing markets, so our stated growth objective for the Company is 10-plus on the top, and 12-plus on the bottom, and certainly in this environment where construction remains soft, the industrial business we expect to be a very important driver of that.

Terry Darling: Okay, and then, I guess, it just—coming back to the contractor 4Q comment. I guess, first off, one less week, is that—we're talking roughly $15 million across the Company, Jim, is that about right?

James Graner: That's reasonable.

Terry Darling: Okay, and, you know, given the tough comp and the commentary about distribution pulling in inventories, does contractor grow organically, you know, in 4Q or is that, you know, you're thinking pretty close to flattish year-over-year?

Patrick McHale: At this point, we're not sure. I think it could be flattish. We could see some growth but, you know, compared to our confidence in our industrial and our lube business, it's—we're just a little bit more cautious regarding what's going to happen with our channel partners.

Terry Darling: Okay, and then just lastly, one modeling nit. The commentary on the deal cost 3Q versus 4Q, does that suggest the corporate expense, you know, within the segment build-up is down 2 million sequentially?

James Graner: I'll try to refine your question, Terry. The corporate expense where we put the transaction cost is not charged against the segment, so, if you look at our segment operating margins for industrial, it's not penalized by the transaction cost, our total Company operating margin is. So it's roughly the same dollar amount in the second quarter, third quarter, and fourth quarter in our projections.

Terry Darling: So that 6.9 million corporate expense line, similar in the fourth quarter?

James Graner: Right.

Terry Darling: Thanks very much.

Operator: Thank you. The next question comes from Matt Summerville from KeyBanc. Please go ahead with your question.

Matt Summerville: Morning, just a couple of questions. I think, if you look at your slides, and I think it's page 17, it was mentioned on the lubrication business, that you had some unabsorbed manufacturing costs or product costs—inefficiencies, maybe is a better to way to phrase it, excuse me. Can you talk about what was driving that factory performance in lube, and I guess, you know, a year or so ago or two years maybe, you had some factory challenges. Does it relate back to that? Because I guess I thought those problems were kind of solved.

Patrick McHale: No, you know, I don't really see that it relating back to that. They've made tremendous improvements over the course of the last couple of years and, again, the division is going to deliver on its commitment to me to have that mid to high teens in operating margins. They have been growing fast, so it's been a really big snap-back for our lube business, and that's created some challenges for them on manufacturing process. In some cases, they're running product on what we call alternative operations, where they're—it's the not primary machine to run it on, but since they're busy, they run it on a less efficient machine, in order to take care of our customers. So we've really been focused on driving throughput and driving some of our customer service improvement metrics, and that's cost us a little bit, particularly in the third quarter. We do have some capital equipment that's been justified by the lube division over the course of this year. It's not here yet. It should start showing up here in the fourth and the first quarter, and as we put that into service, that should give us a little bit more breathing room on the output side, and I would expect that then that will help us get some of the efficiencies back that were given up in order to take care of our customers here.

Matt Summerville: And then, Pat, maybe, could you just spend a minute kind of talking through the three regions, on the industrial side of the business, what you're seeing, plusses and minuses, from an end-market standpoint over the course of the quarter, or in your current incoming order rate?

Patrick McHale: You know, I can't give you any hard numbers, obviously, because we sell through distribution, but in terms of end markets that are doing well, in North America, ag is doing well, we're still getting quite of business in aerospace, automotive has had a really nice rebound off the lowest, the businesses that are tied-in to kind of the big tickets—some are discretionary—the boat business, the RV business, those are still tough. Businesses associated with the construction markets that affect our industrial business, like window and door, those remain challenging, so, I don't think we're really seeing anything significantly different than probably what you're hearing from everybody else, and on the European front, despite maybe a little bit that you hear, our automotive—the automotive investments in Europe still seem to be being made. They haven't seemed to pull back their horns yet, from an automotive standpoint, so our business there is continuing to hold up.

And, of course, the developing markets, whether you're talking about Europe or Asia, are still cooking along at pretty high levels across, I'd say, most of the industry and segments, certainly anything associated with mining, or anything associated with energy production has been pretty good. I can't say that I can pick out a lot of weak areas in Asia. Even Japan for us is continuing to show nice double-digit growth rates for both the quarter and for the year.

Matt Summerville: I appreciate the color. Thanks, Pat.

Operator: Thank you, and the next question comes from Mike Halloran from Robert Baird. Please go ahead with your question.

Mike Halloran: Good morning guys.

Patrick McHale: Morning.

James Graner: Morning, Mike.

Mike Halloran: So first, just to be clear on the tax rate, that 32% you referenced, that's 4Q and for 2012, or is that just 4Q?

James Graner: That's the annual rate we're projecting for—

Caroline Chambers: Eleven.

James Graner: For '11, and if you're modeling 2012, I'd use between 33 and 34.

Mike Halloran: Okay, so it's going to go—track up a touch. Okay, and then, I know you talked about some softening, sequentially, on the contractor side, but, you know, the commentary certainly seems pretty positive on the industrial and the lubrication side. Any reason why you wouldn't see some sort of normal sequential pattern? Anything in the quarter or ahead that you think, in the industrial, lubrication side, would skew that normal sequential trend?

Patrick McHale: If you take out the impact the of the extra week, which I suggest that you do, I don't see anything, other than the concerns about what may happen in Europe, and, of course, today's a happy day, so apparently Europe is now going to be fine, but I'm still concerned about Western Europe, and, although we haven't really seen a significant impact in order rates, I think you'd be wise—a person would be wise to be watching that cautiously. Other than those two things, I feel pretty good about where our industrial and lube business is going, and I think that we're going to continue to perform well.

Mike Halloran: Okay, that's all I had, guys. Appreciate it.

Operator: Once again, if any participant would like to ask a question, please press the star, followed by the one on your telephone. To cancel this request, please press the star, followed by the two.

And as a final reminder, if any participant would like to ask a question, please press the star, followed by the one on your telephone.

If there are no further questions, I would now like to turn the conference over to Pat McHale.

Patrick McHale: All right, well thanks for your participation in our call this morning. Again, we're pleased with the quarter, and generally pretty positive, in terms of our outlook over the course of the next year or two. We think what we're doing is working, and we're going to continue to make those investments. Thanks.

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

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