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EDITED TRANSCRIPT

GGG - Q4 2012 Graco Inc Earnings Conference Call

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OVERVIEW:

GGG reported 4Q12 sales (including $32m from Powder Finishing operations) of $254m and net earnings of $42m or $0.68 per diluted share.

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PRESENTATION

Operator

Good morning and welcome to the fourth-quarter and year-end 2012 earnings call for Graco Inc. If you wish to access the replay for this called, 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 4587286. The replay will be available through February 1, 2013.

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 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 purposes of the Safe Harbor provision of the Private Securities Litigation Reform Act. Actual results may differ materially from those indicated as the 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-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're made. The Company undertakes no obligation to update these statements in light of new information or future events. (Operator instructions)

I will now turn the conference over to Caroline Chambers, Vice President and Controller.

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 discussion on our overall financial results for the fourth quarter and then we will turn the call over to Pat. Slides are available to accompany our call and can be accessed on our website. The slides include information about our consolidated financial results for the fourth quarter in our usual format.

Sales totaled $254 million for the quarter including $32 million from Powder Finishing operations. A table showing impact of volume, acquisitions and currency by segment region is included on page 5 of the slides.

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Translation rates did not have significant impact on sales growth for the quarter. Contractor segment sales were up 13% in the quarter, driven by growth in the Americas. Without the increase in sales in the Industrial segment related to the addition of Powder Finishing, sales in the segment were flat compared to the quarter and the prior year.

Lubrication segment sales declined by 3% in the quarter. Also, without the increase in sales related to the addition of acquisitions and a consistent exchange rate, sales in the Americas grew by 14%; sales in Europe were flat; and sales in Asia-Pacific declined by 17%.

By region, Powder Finishing sales for the quarter were $6 million in the Americas, $20 million in Europe and $6 million in Asia-Pacific. Net earnings totaled $42 million or $0.68 per diluted share for the quarter. We have also included a walk on page 9 of the slide deck which provided a quarter over quarter overview of change in operating earnings.

Gross profit margins as a percentage sales were 55% for the quarter, up nearly 0.5 percentage points from the fourth quarter last year. Lower margin rates on acquired Powder Finishing operations affected the overall margin rate by approximately 1.5 percentage points in the quarter while margins on the legacy Graco operations improved as compared to the prior year with strong operating performance and cost management.

Total operating expenses increased $11 million for the quarter. Powder operations accounted for $9 million of the increase, of which $2 million was intangible amortization.

Acquisition expenses totaled $1 million in the quarter, a decrease of $1 million from the fourth quarter last year.

Our unallocated corporate expenses include stock compensation, pension finance costs and contributions to the Graco Foundation as well as acquisition/divestiture costs. On a quarter-over-quarter basis, we saw an increase in pension expense of approximately $1.5 million.

As noted earlier, acquisition and divestiture costs were $1 million in the quarter, a decrease of $1 million as compared to the fourth quarter last year. $4 million of dividends post-tax were received from the liquid finishing business and are included in other income. Other income also includes $2 million for a nonrecurring reimbursement related to shared employee retention payments.

Interest expense increased by $1.3 million for the quarter as compared to last year due to higher levels of borrowing. Since the purchase of the Powder and liquid finishing businesses in April 2012, we have paid down debt by approximately $80 million.

The effective tax rate for the quarter was 28% as compared to 30% last year. This year's effective rates are reduced by the effects of the investment income from liquid finishing businesses held separate and the effect of a tax rate change on deferred liabilities from a tax holiday that was received in a foreign jurisdiction. Our usual slides about segment results are also included in the slide deck starting on page 13.

Net cash provided by operating activities was $58 million for the quarter and $190 million for the year. We are managing working capital in line with business volumes. Capital expenditures were $18 million and we paid dividends of $54 million for the year. Earlier in the year, we also made a voluntary $10 million contribution to our US funded pension plan.

Our outstanding long-term debt declined from $33 million during the quarter to $556 million.

Very briefly, I will discuss the accounting for the liquid finishing business that is reflected as a cost investment on our balance sheet. Under terms of the hold separate order from the Federal Trade Commission, we cannot exercise direction or control of the operations of liquid finishing, nor are we able to exert significant influence over the liquid finishing operations.

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, i.e., post-tax, and is included in other income in Graco's income statements.

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Dividends from the liquid finishing business total $4 million in the fourth quarter and were $12 million in the nine months since the acquisition. We anticipate a steady rate of quarterly dividends as long as this investment is held.

Looking forward, I would also like to mention a few other items. Going into 2013, we expect pricing to align with inflation and continued factory improvements and efficiencies resulting in modest cost improvement. We anticipate that the total future cost of the divestiture will be approximately $10 million, though the timing of the expense and the final amount will be affected by the sale and regulatory review process.

Our annualized 2013 tax rate is anticipated to be between 32% and 33%, assuming the $4 million in post-tax dividends per quarter from the liquid finishing business as long as we hold it. The reinstated federal R&D tax credit will have a favorable effect in the first quarter of 2013 and will include a catch-up for 2012 of approximately $2.5 million resulting in a tax rate for the first quarter of 31% to 32%.

We expect the annual pension expense to be $2 million lower as compared to 2012. We may elect to make a voluntary contribution to the US funded pension plan this year in the range of $10 million. Capital expenditures are expected to be around $25 million in 2013.

With that I will turn the call over to Pat for more comments on our results.

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

Thank you, Caroline. Good morning, everyone. This morning I will give you some color in the trends we saw in our business in the fourth quarter and our views as we move into 2013.

Generally, I was pleased with the performance of the Company in the fourth quarter. Of particular note was the excellent performance of all of our factories, driving significant quality and process improvements across product categories.

Gross margins on an as-reported basis improved from the fourth quarter of 2011 to the fourth quarter of 2012 by about 40 basis points. The difference between those two periods, however, is the addition of the Powder Finishing business, which actually diluted margins by 1.5 percentage points. In other words, the legacy Graco operations improved gross margins by nearly 2 percentage points year-over-year. My thanks go out to all of our purchasing, manufacturing, distribution and customer service employees for another fine year in 2012.

The Americas Contractor business had a strong showing in Q4 after a weaker-than-expected Q3. The improvement was a combination of good team performance, a recovering construction market, new product and easier comps versus a weak Q4 of 2011.

Outside the Contractor business, I would say that the business environment for the legacy Graco operations is relatively unchanged from the third quarter. Europe is stable with growth in the east and headwinds in the west. Asia-Pacific remains challenging throughout the region and across product categories.

On Graco legacy business, we knew we had a difficult comp in the fourth quarter versus 2011. Our hope was to try and build from the run rate of the third quarter of 2012 and gain some momentum going into 2013. Unfortunately, shipments were spotty in the fourth quarter and sales were down 4% sequentially. I will get into the details more in a moment.

Focusing on to the Powder business, which we are managing on a worldwide basis, I'm very pleased with Powder performance for the year, and particularly our fourth quarter. Top-line performance was in line with expectations and gross margins and operating margins have improved each quarter since the acquisition, resulting in bottom-line performance above expectations. The Gema team and Graco team are working very well together and I look forward to continued progress in 2013.

Next, let's walk through each of the regions and segments for the legacy Graco business and I will briefly give you a few data points and our go-forward outlook. My comments are based on year-over-year performance on a constant currency basis.

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First, let's go back to Asia-Pacific. Sales declined in each of our reporting segments in the Asia region during the fourth quarter. As stated earlier, this wasn't surprising due to difficult comps from the prior year, but the performance was disappointing, nonetheless. Across the board, activity levels had been stagnant since late in the first half of 2012, which we expect will continue into the first half of 2013.

Industrial segment sales in Asia were off 15% from the fourth quarter of 2011, although from an incoming order perspective, bookings in the Industrial segment showed some growth from Q3 and our backlog grew in the fourth quarter. This was mostly due to timing as we had a nice spike of orders in late December that was scheduled for shipment in the first quarter of 2013.

Order activity was a mix of distributor and end-user stocking orders as well as some larger automotive project activity in China and Korea. Currently, we are booking on trend with the averages we experienced over the second half of 2012.

From an end market perspective, when compared to the prior year, we are seeing a similar story to what we discussed in the third quarter. Automotive production levels are holding steady, but other industries, such as wind, solar, construction equipment and shipbuilding remain soft. Our Contractor business in Asia-Pacific was down 7% in Q4 versus the prior year. Sales were flat sequentially to Q3. We continue to work our key initiatives, including, most importantly, end-user conversion.

Lubrication sales in Asia posted a 40% decline from the prior year. The biggest driver of the decline is the slowdown in mining activity. As most of our investors know, we are in the early innings with our industrial lubrication line. A lot of the share gains that we have made in Asia over the past two years have been in the mining space, which has seen CapEx under pressure in the past six months. Sequentially, loop sales in Asia were flat out, so we believe we have likely hit the bottom from an incoming order rate perspective.

Moving onto EMEA, the emerging markets of EMEA continue to grow nicely for us, led by Russia and Central Europe, while we saw an overall reduction year-over-year in the West. The mix of sales between the West and the East were similar to the third quarters at approximately 60% West and 40% East.

From an end market perspective, Western European activity is weak across the board from construction to automotive to general industry. We have had some wins in automotive, which has helped keep our industrial sales close to the level achieved in 2011 while our Contractor business continues to make gains in the emerging markets to offset the Western European declines.

The growth of Lubrication in Europe in Q4 was nice, but it is coming off a small base and as a result, quarterly results can be choppy. We believe conditions into Western Europe will be soft into 2013. We continue to focus on the emerging markets to try to outperform what the market gives us.

Onto the Americas. I'm very happy with the growth rates achieved in all of our segments in the Americas in the fourth quarter, capping off a really nice year of nearly double-digit growth for Graco in the region. Our Industrial segment grew at a double-digit pace, reflecting strength across a range of end markets. We are optimistic for continued growth in this segment in the Americas in 2013, albeit at a slower pace as we lap strong comps throughout the year.

Our Lubrication segment grew at a high-single-digit pace in the fourth quarter in the Americas with contributions from both the legacy, petroleum management products as well as our industrial lubrication lines. We are expecting both product categories will continue to drive growth into 2013.

Lastly, we look at the Contractor segment in the Americas, which grew at a very strong double-digit pace in the fourth quarter. Results were a combination of good performance by the team, easier comps from Q4 of 2011, a recovering housing market and probably some bounce-back from Q3, which was softer than we had expected. As the housing market recovery continues, we anticipate that we may see some choppiness from quarter to quarter, although the overall trend should be favorable.

During Q4, we experienced strong double-digit sales increases in both the paint stores and the home centers. Out-the-door sales were good in both channels and our data indicates that inventory levels with all of our partners are appropriate, so we are not expecting significant changes in

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2013 related to stocking. We saw good growth in all product categories; however, the mix still remained skewed towards the units with lower output.

Lastly, we had indicated previously that there was a pending new product launch in Contractor that would give us additional sales volumes. The product did launch late in the fourth quarter and contributed a few percentage points to Q4 growth rate. The product is an extension of our handheld line that is targeted for heavy-duty applications, particularly protective coatings. The HD unit, as it is called, is appropriate for touch-up work on bridges, ships, pipelines and other metal applications that are exposed to the elements. Initial response from our channel partners and distributors has been good and we are looking for this product to contribute about 1 percentage point of growth to the worldwide Contractor segment in 2013.

A few comments regarding overall outlook -- looking at the demand side as we enter 2013, we expect continued variability in performance between regions. The Americas was our best-performing region in 2012, and we anticipate this will continue in 2013. For the full year 2013, we expect all segments will grow in the Americas, led by Contractor with low-double-digit growth and anticipate Industrial and lube to generate mid-single-digit growth. We expect EMEA will be a struggle throughout the year due to the lack of any real help from the macro environment in Western Europe. We look to further penetrate the emerging markets and are expecting to see overall growth in EMEA in 2013, albeit at a low single-digit rate.

In Asia-Pacific, we expect to end 2013 with overall single-digit growth, but with tough comparisons the first half will likely see our trend negative year-over-year growth continuing.

Despite the challenges in EMEA and Asia, we like our strategic plan and we are committed to finding initiatives that have a long-term return for our shareholders. We're constantly analyzing returns we are achieving from those initiatives and will make adjustments as needed to ensure the ROI is there. The Graco team is focused on execution, selectively adding distribution, growing our end markets, broadening our geographic reach, converting end users from manual application methods to sprayers and developing and marketing best-in-class new products. We also expect our factories will continue to perform in 2013 and contribute positively to our results.

A few comments on the liquid finishing divestiture process -- there isn't much that we can say publicly that is different than what has already been said. The final decision and order from the FTC has not yet been issued and the timing of the order is unknown to us. As stated on last quarter's call, the delay is related to some intellectual property matters that Graco does not believe are material to the overall operations of the business.

That being said, the FTC has been focused on that matter and actions are being taken.

Due to the nature of our ownership structure, the hold separate arrangement and the FTC's involvement, we are aware of what is happening, but our role is very limited. Due to the relative size of the matter, we are not expecting the outcome will have a material impact on our ability to sell the business or our ultimate proceeds.

Unfortunately, I am not in a position to give much more detail.

In the meantime, though, the business continues to perform well, posting another quarter of growth in sales and EBITDA. We're the beneficiary of the cash that is being generated by the business and we remain confident that there will be significant in the asset.

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

QUESTIONS AND ANSWERS

Operator

(Operator instructions) Charley Brady, BMO Capital Markets.

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Charley Brady - *BMO Capital Markets - Analyst*

Just on the Contractor business, I just wanted to understand a little bit more what happened in the quarter. So you had a new product launch, which helped a little bit toward the tail end, and you also had maybe a little bit of bounce-back from Q3. And I guess what I'm just trying to understand -- as we look into 2013, particularly Q1 of 2013, should we expect that growth rate to tail off? It sounds like you have got a couple things that helped to give a little bit of bounce in Q4 that maybe don't carry through as strongly going into the first half of 2013.

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

Yes. I don't want to start slicing our projections quarter by quarter, but our projection is that the environment is going to be good for us here in the Americas in 2013 and that we would expect the Contractor division over the course of the year to end up with growth in that low-single-digit range.

Charley Brady - *BMO Capital Markets - Analyst*

Okay, and can you just clarify --

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

Excuse me, sorry. Jim just interrupted me, brain cramp. It was a low double-digit range.

Charley Brady - *BMO Capital Markets - Analyst*

Okay, that makes a lot more sense, then.

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

Thank you. I just dropped $20.

Charley Brady - *BMO Capital Markets - Analyst*

So you are still okay. On the other expense line you went through and I missed part of what you said about the extra $2 million. What was that related to?

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

So, we are talking about the extra $2 million in other income?

Charley Brady - *BMO Capital Markets - Analyst*

Yes.

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

So what we had there was a nonrecurring reimbursement of $2 million that was related to some shared employee retention payments.

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Jim Graner - *Graco Inc. - CFO, PAO, Treasurer*

So, Charley, you can think of it similar to the dividend distribution we received from the liquid finishing. The only difference is the $2 million is pre-tax, and the $4 million is after-tax.

Charley Brady - *BMO Capital Markets - Analyst*

And then that's a nonrecurring -- that's a one-off type thing this quarter; correct?

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

Correct.

Jim Graner - *Graco Inc. - CFO, PAO, Treasurer*

Correct.

Charley Brady - *BMO Capital Markets - Analyst*

Okay, thanks.

Operator

Liam Burke, Janney Capital Markets.

Liam Burke - *Janney Montgomery Scott - Analyst*

On the Lubrication side, and I know you had some tough sledding in southeast and the Asia-Pacific area, but you did have year-over-year decline in revenue but a significant step up in operating margin, so it couldn't be just volume improvement. Where did you see the improvement? Where did you see the profitability improvement?

Jim Graner - *Graco Inc. - CFO, PAO, Treasurer*

Liam, just to come back to your comment, the segment declined for the quarter 3%

Liam Burke - *Janney Montgomery Scott - Analyst*

Right.

Jim Graner - *Graco Inc. - CFO, PAO, Treasurer*

What it did grow is -- for the year for 7. But the improvement in operating performance in the fourth quarter really comes as a result of improvements in our factory and what we are able to deliver on margin prospectus. Caroline, do you want to add anything?

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

Just correct on that, so we saw nice improvements coming out of the factory really and they ramped up as the year went by.

Liam Burke - *Janney Montgomery Scott - Analyst*

And just to talk a little bit more about, on the Industrial Lubrication side, you saw obviously the mining in Asia-Pacific was tough. Are you seeing on other segments success and market share gains there?

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

Yes, it's really hard to measure without any sort of industry data on that. We are seeing nice growth in that category over the course of the last 3 or 4 years as we have really started to improve our product position, and we believe that our growth in that category has been better than what the market is doing so we can assume some market share gain, but it's hard really to put a metric on it. Keep in mind that our market share in industrial lube is probably about 3% overall.

Liam Burke - *Janney Montgomery Scott - Analyst*

Great, thank you.

Operator

Jim Foung, Gabelli & Company.

Jim Foung - *Gabelli & Co. - Analyst*

Hi, good quarter. When I look at the Contractor business, your peak was about $320 million going back to 2006. It looks like you are already approaching that on the revenue basis. The margins at that time was about 28%, and I guess you are doing about 18% now. So I guess the question is, how long would it take you to get back to those peak type of operating margins that you had in the last cycle?

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

I will make a couple of comments, and then Jim can jump in maybe with some more granularity. But the way to think about the Contractor revenue line today versus where it was that in 2006 is the revenue line is made up of a fairly significant different mix. We are still somewhere in that $70 million to $90 million maybe plus shortfall in our base business product categories, and we have made a lot of that up with our growth in some of the emerging markets and with a lot of the new product that we have launched over the years.

The incremental margins on that product compared to what we had on the base business is still a significant headwind for us. So from my perspective, we are going to look at operating margins and Contractor should continue to improve as the base business improves, but we would not be looking for mid-20s until we have housing starts and the corresponding underlying core product strength in that 1.5 million housing starts range.

Jim Graner - *Graco Inc. - CFO, PAO, Treasurer*

You are right that in total, we are getting close to back to the peak. When we look at the business in North America and we strip out the additional products we launched in the last three or four years from our total market initiative, we still think we are about $80 million in that legacy business under the peak. And as Pat mentioned, a lot of that $80 million came from the high-end units that probably will take us -- take the housing

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environment of more than 1.5 million for us to achieve. So we will see a slow improvement in the operating margins, but at the next -- this cycle, until the housing starts get well over 1.5 million, I don't think we will approach the 26% to 28%. That will be more in the low 20%s -- 23%, 24%.

Jim Foung - *Gabelli & Co. - Analyst*

So that would be tied to the new kind of target we can kind of look at as the housing market improves?

Jim Graner - *Graco Inc. - CFO, PAO, Treasurer*

Correct.

Jim Foung - *Gabelli & Co. - Analyst*

Okay, great, thank you.

Operator

Kevin Maczka, BB&T Capital Markets.

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

Pat, first on the gross margin, it doesn't sound like there was anything unusual there that helped you this quarter, like mix or anything else. I think you called out pricing, volume and factory efficiencies. Since there wasn't much in the way of organic volume growth, I'm wondering -- can you say a little bit more about the magnitude of the pricing impact? Are there specific things that are happening in your factories now to drive that, other than your ongoing normal continuous improvement?

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

I will make a couple of comments about the factories and then let Jim weigh in on pricing.

We continue to invest capital in our factories, and really throughout 2012 both with capital that we justified in 2011 and we put in place in 2012 and with the capital that we are putting in place, we saw the factories have good cost improvements throughout the year and gain momentum. And just good work done by folks on cost reduction, kaizens, capital equipment installations drove that trend. It wasn't any one product line or anyone factory; it was pretty broad-based improvement by all the groups.

Jim Graner - *Graco Inc. - CFO, PAO, Treasurer*

For the quarter, the one thing that stands out is the fact that our factory delivered a 1 percentage point improvement in the gross margin just from their inputs and productivity. That compares to a flat kind of number for the year. So in other words, our costs were flat for the year but actually improved gross margins in the quarter by 1 percentage point.

So the pricing impact on the quarter was basically the same as it has been year-to-date, and the incremental margin improvement here is coming out of the factory and impairment side.

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

And Jim, you are ramping CapEx in 2013. Any specific projects there that we should be aware of?

Jim Graner - *Graco Inc. - CFO, PAO, Treasurer*

It's really just volume dependent. You probably also saw that our actual number for 2012 was less than we had told you in the second and third quarters. And really, that's a deferral of CapEx projects that are volume-related, and those will happen in 2013.

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

Got it. And then just finally from me, a general question related to ITW and the FTC. You don't, of course, have to sell that yet until you get the final verdict from them or decision from them, but is there anything that inhibits you from just going ahead and doing that, assuming you have a buyer at a suitable price?

Jim Graner - *Graco Inc. - CFO, PAO, Treasurer*

Well, we have to file an application with the FTC, and the application will disclose the buyer. The FTC does have to rule that the buyer is able to keep competition in the marketplace. So we can't pick a buyer and sell and close on that without the FTC's approval.

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

Okay, so you are just still in limbo of sorts until you get the decision?

Jim Graner - *Graco Inc. - CFO, PAO, Treasurer*

Correct.

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

Yes, okay.

Jim Graner - *Graco Inc. - CFO, PAO, Treasurer*

Because we don't want to get ahead of ourselves.

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

Yes, okay, thank you.

Operator

Matt Summerville KeyBanc.

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Matt Summerville - *KeyBanc Capital Markets - Analyst*

A couple of questions -- first, on the Powder portion of the business, you have had that now for just under a year. As you look over the next one-year period and maybe then thinking longer-term 3 to 5 years, how would you characterize your expectation in terms of how fast that business should grow organically and what an acceptable margin trajectory would be for that business? And, now that you have been in it for a year, again, do you think 30-plus is in the cards like the remainder, you know, the legacy Graco business as it pertains to the Industrial segment?

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

On a top-line perspective, that business has got a fair amount of exposure to Europe. So over the short term, that could be a bit of a challenge for us. But they also do very well in Asia and have seen good growth there historically.

So our view when we bought that business is that it would be equivalent or maybe slightly better than the average growth rate that we see in other coatings businesses on the industrial side. So it should be a neutral to a positive from our overall industrial growth standpoint.

You will also recall that this is already a well-performing business and our strategy on this thing from an integration standpoint was to make sure that we protect revenue. So we have been executing along those lines and would expect to see some modest improvements in gross margin, both by pricing actions and by cost reductions as we move forward, but not any kind of a dramatic increase.

I don't view this business as having the same upside in terms of operating margins that our legacy Industrial business, primarily because they sell a lot of, I will call it sheet metal, plastic-type components along with the system, the booths, the recovery systems that you are just not likely to see the sort of margins that we would see on their base value-added engineered product.

Matt Summerville - *KeyBanc Capital Markets - Analyst*

Got it. And can you maybe talk to a little bit more about China and some of the emerging markets outside of Europe? I thought you hit on that in a pretty detailed manner. Has your bidding activity improved at all in China? Are utilization rates an issue that is maybe impacting your aftermarket business there? Help me understand more about what you are seeing real time. Some companies are starting to be a little more optimistic about China, and maybe I'm misinterpreting, but I am not seeing that from you guys.

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

I would say that we are more optimistic about the second half of the year, and I think just our culture here is that we think that is dangerous, to be always excited about the second half of the year.

Looking at it in the short term, our run rates in Asia in general seem to be starting the year out on the same path as they were at in the second half of 2012. The factories aren't being used in China and we haven't seen a big drop-off in our spare parts business.

But it was really general softness across the industries, probably also driven by a little bit of pullback on CapEx. GDP was still good in China in 2012. We would love to have a number like that, but the fact that it was a little bit less than prior year, I think, caused people to utilize the investments that they had in place and a little bit less focus on putting new capability in place. So I think that hurt us on the project side.

We anticipate there could be another six months of that before we start to see the kind of investments at the level that we need to get, to get that double-digit Asia growth back.

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Matt Summerville - *KeyBanc Capital Markets - Analyst*

And then just one more, Pat. In EMEA and Asia-Pac, you provided a little bit of real-time end market color. Can you do that just for the Industrial business in North America, what you saw and what you expect as we moved through the year?

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

Well, we had a really strong year so, obviously, comps are going to be more difficult. But we saw strength across really a lot of different end markets. In fact, we just finished up our Industrial sales meetings that kicked off the year here in the last couple of weeks, and I would say the overall tone of the salespeople is positive. They continue to see people making investments. Even in industries that maybe aren't going that strong, people are looking for cost reduction opportunities and process improvement. And I think we are feeling generally pretty decent about 2013 for Industrial.

Matt Summerville - *KeyBanc Capital Markets - Analyst*

Thanks, guys.

Operator

Jim Krapfel, Morningstar.

Jim Krapfel - *Morningstar - Analyst*

What inning do you think we are with regards to the margin recovery in the Lubrication segment? Do you think this business will achieve mid-20% margins within the next 3 to 5 years, as I think you have previously articulated?

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

Yes, I'm not sure exactly what the time frame is. We've seen continuous improvement now over the course of the last few years and their expectation was is that they would get up over that 20% number for 2012, and they did that with some top-line growth. I think we will continue to see modest improvement in that. We are investing to grow that business with a 3% market share in Industrial Lube. There's lots of opportunity for us to push that product around the world, and we also need to do some things on the product development front.

So if Lube has a decent year and they add 1 point, 1.5 points to their operating margin in 2013, I will be happy. And we don't have a big push on right now to jam them back into the mid-20s. We could do that by doing some significant expense reductions, but we like the investments that we are making in that space and we are going to be patient.

Jim Krapfel - *Morningstar - Analyst*

Okay, that makes sense. Second question -- certainly economic conditions will make segment results choppy, but would you estimate the annual revenue boost you receive from converting users to spray equipment in Europe and Asia-Pacific (inaudible) of Contractor segment?

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

Man, that's almost impossible to measure. If I tried to throw a guess out there, Jim would probably jump across the table and tape my mouth shut.

We launch new product every year. We add people in the emerging markets. We have a good distribution channel ad program in place. We are doing specialization, and so there is really no way to accurately measure the impact of any particular initiative.

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But I will tell you, we really believe in end user conversion and we do thousands of end user conversion demonstrations every year. And we have dedicated people, not salespeople, but we have dedicated end user conversion people in Europe that are going around doing that activity.

So we think it's really important. And if you take a look at the paint consumption there compared to the amount of equipment that's sold, you can see that the runway is long.

So we just continue to try to drive that, but an exact measurement is really difficult.

Jim Krapfel - *Morningstar - Analyst*

Okay, thank you so much.

Operator

Mario Gabelli, Gabelli & Co.

Mario Gabelli - *Gabelli & Co. - Analyst*

We're not double-teaming you, but Jimmy is on the sell side, and I didn't know what he was going to ask. He's new (laughter). When I look at the amount of, say, dry powder in your financial statements, or I should say electrostatic powder that you are going to get back, what is on your drawing board in terms of tuck-in deals? You did a fairly significant with ITW, obviously, and it ran into a speed bump. You must have a pipeline full of acquisitions. Do you not do them while this ITW transaction with the FTC is pending, or do you just move ahead at some point?

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

Well, if we found the right deal, we would absolutely move ahead. As you know, people are paying up pretty substantially for deals in the flow control space right now. We do have a number of folks at Graco that have been working pretty hard that build a vision of where we want to go and identifying candidates. And we are going to be careful we don't overpay as well.

Mario Gabelli - *Gabelli & Co. - Analyst*

Obviously, you could put a wrapper around the sale of the electrostatic business and get a fairly -- you have a number that you have; it's financeable. So there's no concerns over size anymore? The last one was pretty sizable.

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

Yes, I think that, as an organization, we are getting better. We actually started doing some deals back about 10 years ago and we have gradually improved, and of course the capability of that organization to execute as well as our capability to identify spaces is getting better. So I think we are comfortable doing things that are bigger, but again, I think we are going to keep our discipline and we are not going to do something just to do it and we're not going to overpay. We need to find something where we can add value, particularly in our core competencies on the manufacturing and engineering new product front, and if we found something that was sizable we would figure out how to finance it.

Mario Gabelli - *Gabelli & Co. - Analyst*

One minor edit -- I don't think you are in limbo, I think you are in hell on this one. (Laughs) take care, thank you.

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Operator

As there are no further questions, I will now turn the conference over to Pat McHale.

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

Thank you very much for your participation this morning and we look forward to talking to you again in a few months.

Operator

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

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