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GGG - Q1 2013 Graco Earnings Conference Call

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OVERVIEW:

GGG reported 1Q13 sales (including $32m from Powder Finishing operation) of $259m and net earnings of $52m or $0.84 per diluted share.

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CORPORATE PARTICIPANTS

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PRESENTATION

Operator

Good morning and welcome to the first quarter 2013 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 and Canada. The dial-in number for international callers will be +1-303-590-3030. The conference ID is 461-2085. The replay will be available through April 28, 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 the opening remarks from management.

During this call, various remarks may be made by the 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 2012 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. (Operator Instructions). I will now turn the conference over to Caroline Chambers, Vice President and Controller. Please go ahead.

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

Good morning everyone, I'm here this morning with Pat McHale, Jim Graner and Christian Rothe. I'll provide some top-level discussion on our overall financial results for the first quarter and then we'll turn the call over to Pat.

Sides are available to accompany our call and can be accessed on our website. The slides include information about our consolidated financial results for the first quarter in our usual format.

Sales this quarter totals $269 million including $32 million from the Powder Finishing operations acquired in April 2012. Sales from legacy operations increased by 1% for the quarter, and trends varied by division and region. Without Powder, sales were up 4% in the Americas, led by the growth in Contractor segment sales, with strong sales in both the paint store and home center channels.

Sales were down in EMEA and flat in Asia-Pacific. Sales from legacy operations in the Industrial segment were down 2%, mostly from an 8% decrease in EMEA.

Lubrication segment sales decreased 3%, where several large industrial lubrication transactions in 2012 and Asia-Pacific not repeat in 2013. Changes in currency translation rates did not have a significant effect on either sales or operating results. A table showing impact of volumes, acquisitions and currency by segment and region is included on page 6 of the slides.

Net earnings totaled $52 million or $0.84 per diluted share for the quarter. Page 8 of the slide deck provides a quarter over quarter overview of change in operating earnings.

Gross profit margins as a percent of sales were 56% for the quarter down 0.5 percentage points from the first quarter of last year. Lower margin rates on acquired Powder Finishing operations were nearly offset by realized price increases and manufacturing cost improvements. Total operating expenses increased $5 million for the quarter, including $9 million from Powder Finishing operations.

Acquisition divestiture expenses in this quarter were negligible and down $4 million from the first quarter last year. $4 million of dividends post-tax were received from the Liquid Finishing business that is accounted for as a cost method investment and were included in other income.

The effective tax rate for the quarter was 27% as compared to 34% last year. The federal R&D tax credit was renewed in the first quarter 2013 and was retroactive for 2012. The first quarter rate includes the full amount of the 2012 credit as well as the credit for the first quarter 2013. There was no R&D tax credit recognized in our 2012 results.

The first quarter tax rate also reflects the effect of the after-tax dividend income received in the Liquid Finishing business that's held separate, the favorable resolution of open items during a tax audit, and various other estimates affecting federal, state and foreign taxes.

We have included our usual slides about segment results in the slide deck starting on page 12. Net cash provided by operating activities was $39 million for the quarter, with changes in working capital in line with business volumes and consistent with prior quarterly trends. Capital expenditures were $3 million and we paid dividends of $15 million.

Our outstanding long-term debt declined by $35 million during the quarter to $521 million.

I'll very briefly 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 controlled operations in Liquid Finishing, nor can we exert significant influence over the Liquid Finishing operations. Our investment in the Liquid Finishing business continues to be reflected as a cost method investment, and the Liquid Finishing financial results are not consolidated. Income is recognized based on dividends received from current earnings, i.e. post-tax, and is included in the other income in Graco's income statement.

Dividends from the Liquid Finishing business totaled $4 million in this quarter.

To reduce cash in undistributed earnings held in Liquid Finishing, we are evaluating the possibility of a dividend of between $10 million and $15 million in the second quarter, with a return to a dividend rate of $4 million in the following quarters. We anticipate that the total future cost of the divestiture will be approximately $10 million, though the timing of expense and final amount will be affected by the sale and regulatory review process and duration.

The tax rate for the second quarter is expected to be approximately 30% to 31% with an annual rate of approximately 29% to 30%. Capital expenditures for the year are expected to be in the range of $20 million.

With that I'll turn the call over to Pat for more comments on our quarter.

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

Thank you Caroline, and good morning everyone. This morning I'll give you some color on the trends we saw in our business the first quarter and our outlook for the balance of the year.

The first quarter played out generally in line with the outlook we gave in January, with a significant exception regarding our Industrial segment North America. Our Industrial segment was very strong in North America in 2012, and coming into Q1 I expected lower growth, but decent growth nonetheless. Actual performance for our legacy Industrial segment North America was very flat. I'll give more color in a few moments.

While disappointed with our organic sales growth in the quarter, I was very pleased with our operating performance and with our earnings. Our factories continue to perform well and our business units controlled spending while continuing to push our key growth initiatives.

Gross margin performance was strong both with our legacy business and with the acquired Powder business. The Gema Powder business continues to perform and our integration plans are on track. This is the last quarter that Powder is not in our prior year comparisons, and beginning next quarter we don't plan to share business specific details on our Powder business. This was a good acquisition and our shareholders are getting the return we anticipated.

Next, let's walk through each of the regions and segments for our legacy Graco business and I'll briefly give you a few data points. My comments are based on year over year performance on a constant currency basis, and excluding the impact of the Gema Powder acquisition.

First, Asia-Pacific. Overall, Asia-Pacific was flat against strong 2012 Q1 comparables and performed slightly better than anticipated in the quarter. Our Industrial segment posted mid-single-digit growth and our Contractor business posted low single-digit growth, while our Lube business was down double-digit.

The decline in Lube is expected, as our key mining accounts had a strong first-half of 2012 but weakened dramatically in the second half of the year. Excluding a couple of large mining accounts, our Lube business grew in Asia-Pacific.

During the quarter, demand was highly variable country to country and across product lines. We saw moderate growth in China, nice growth in Korea, particularly for China-bound projects. But significant softness in mining hurt performance in Australia and Southeast Asia.

Now, moving on to EMEA, EMEA continues to be challenging as expected. During the quarter we had nice growth in our Lube business and we are pleased to eke out some growth in our Contractor segment. Our Industrial segment was down with general weakness across product categories. The emerging markets, with low single-digit growth, outperformed the Eurozone, where sales declined mid-single-digits.

From an end market perspective, Western European activity remains quite weak across the board from construction to automotive to general industry. We don't see any catalysts for short-term improvement in the end markets, although we do have new products and selling initiatives and are working hard to find opportunities. We still see growth opportunities in the East and believe that the smaller rate of growth in the East in Q1 was a pause as opposed to a trend.

Now, on to the Americas. As expected, our Contractor segment performed well with double-digit growth during the quarter. Both paint store and home center are doing well with double-digit increases in bookings. Reports from the field are positive and we continue to expect double-digit growth from Contractor North America for the full year.

Profitability also improved nicely, as increases in volume on core products flowed dollars through to the bottom line, and we had a slight improvement in mix.

As discussed in previous quarters, we're not expecting the housing recovery to be a straight line so performance from quarter to quarter could vary.

Our Industrial segment was down slightly, which was a bit of a surprise. Production levels at our end users appear to be reasonably healthy, but we're definitely seeing signs of caution when it comes to capital spending.

The weakness was relatively broad-based, with the exception of process applications which posted single-digit growth. While it's only one quarter, I am concerned, and we are watching this closely.

Our Lubrication segment grew slightly in the first quarter, with low single-digit growth in our legacy vehicle service business and the low single-digit decline in our Industrial Lube business.

Now for our outlook. Our outlook for the year is relatively unchanged from a quarter ago. We expect full year growth in every region. The Contractor segment in the Americas should grow at double digits for the year, but we continue to expect low to mid-single-digit growth and Industrial and Lube in the Americas.

Based upon the first quarter and due to our general lack of visibility due to our short cycle business, there may be some downside risk to the Industrial and Lube growth projections for the Americas.

As discussed on the call in January, we continue to 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, however, 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. The second quarter is likely to be challenging, with comparisons getting easier in the second half of the year. While business conditions remain spotty, we believe end markets will provide opportunities for growth and we're working hard to get new product sales and expand our distribution coverage, as well as to drive end-user conversion in our Contractor segment.

In summary, our overall outlook for 2013 is unchanged, although a few of the pieces have moved a bit since our call in January. We do have some downside potential in the Americas and Lubrication and Industrial. Potential upside, though, is in our factories and overall margin improvement. This provided a benefit in Q1 and we are optimistic for the remainder of the year.

A few comments on the Liquid Finishing divestiture process. There isn't much that we can say publicly that is different than us 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 delays related to some intellectual property matters that Graco doesn't believe are material to the overall operations of the business. That being said, the FTC has been focused on those matters and actions are being taken. Unfortunately I'm not in a position to give much more detail.

In the meantime, though, the business continues to perform well. We are the beneficiary of the cash that is being generated by the business and we remain confident that there will be significant interest in the asset.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Charles Brady, BMO Capital Markets.

Andrew Dunham - *BMO Capital Markets - Analyst*

This is Andrew Dunham for Charlie Brady. I was wondering, with Contractor kind of product mix, have you seen any shift towards kind of the higher-margin sprayers? I was wondering if you might be able to breakout kind of the sprayer versus the aftermarket attachments, kind of what the mix was in the quarter.

Jim Graner - *Graco Inc. - CFO*

Andrew, we're not yet seeing the shift that we expect to see once the market gets -- I'll say the construction market gets stronger. We still have more growth in the smaller units than in the larger units, so there was not a favorable shift on the product mix. What you're seeing is some benefits of improved factory performance, better absorption, cost reduction and a small increase in operating profits.

Andrew Dunham - *BMO Capital Markets - Analyst*

Okay. And how about on a monthly basis? How did Industrial look throughout the quarter, and if you had any insight into April?

Jim Graner - *Graco Inc. - CFO*

Sure, so I would say March was better than January and February. April seems to be not continuing to that same level of improvement, but more along the line of the full quarter, in particular in North America.

Andrew Dunham - *BMO Capital Markets - Analyst*

Okay, and just given kind of the recent FTC settlement that you guys had, does that pave the way for now the FTC looking at a final order for the ITW transaction? And does that in any way kind of potentially maybe change how the SEC might make the outcome for the ITW transaction?

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

I don't see any linkage between the two in terms of the final decision -- the nature of the final decision. There is some overlap with FTC staff working on both, so potentially that could help us get to a resolution on the Liquid. But, again, there are some other issues and it's not clear to us whether this will make a big difference or not.

Andrew Dunham - *BMO Capital Markets - Analyst*

Okay great. Thanks guys.

Operator

Joe Ritchie, Goldman Sachs.

Joe Ritchie - *Goldman Sachs - Analyst*

Good morning everyone. So, nice quarter specifically around your execution on the cost side. On your Industrial business, you were particularly strong. Is there any way you can breakout your Gema margin versus the legacy margins, because they did suppress the upside, at least versus our expectations this quarter?

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

Yes, we saw good performance across both the Gema business and our Industrial business. And I don't want to start breaking out the margin performance by product category. From a competitive standpoint, that doesn't really help us much.

Joe Ritchie - *Goldman Sachs - Analyst*

Okay, well then maybe given the fact that you saw organic growth down in Industrial this quarter, how should we think about the trajectory for the rest of the year on the margin side, given that you were able to take out some costs and had some productivity improvement despite no leverage -- no volume leverage?

Jim Graner - *Graco Inc. - CFO*

So we're pleased with the margins that we reported for the quarter. We expect modest growth, as Pat mentioned, on the geographies for the rest of the year. So I would say our margin for the segment will be stable to slightly improving as the volumes pick up.

Joe Ritchie - *Goldman Sachs - Analyst*

Okay. I guess maybe one last question on -- Asia-Pac seems to be turning a corner, it seems to be getting slightly better. Perhaps any more color that you can provide in that segment, because we've heard conflicting reports out of different companies that have been reporting this quarter so far.

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

It was a little better in the first quarter than I thought it was going to be. I'm not ready to say they've turned the corner. I think second-quarter is going to be tough. We've got big comparisons.

But in the second half of last year they really fell off. And with the initiatives we've got going on in the new products, our team is feeling much better about the second half. I think the second quarter will probably be our biggest challenge, on a comparison basis, for Asia-Pacific going forward.

You know, we saw some automotive project activity. There's still things going on in construction in China. Mining still seems to be really weak. So it's a mixed bag and I think predicting that they've turned the corner I think might be a little bit premature, but I also don't see a collapse.

Joe Ritchie - *Goldman Sachs - Analyst*

Okay, thanks for the color. I'll get back in queue.

Operator

Kevin Maczka.

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

Jim, I had a couple margin questions. Can I just go back to what you said about Industrial? I know you don't want to break out the Powder business versus the legacy, but the segment margin improved so much sequentially compared to what we saw the last three quarters. And I suspect that's more on the core side of the business than any big step up in Powder.

First, can you just talk about that? And did you say that that margin we just saw of [33.6] is what we ought to expect kind of as a sustainable rate from here?

Jim Graner - *Graco Inc. - CFO*

I will just comment that the Powder operations continues to perform well. The margins are expanding there, along the lines with what we talked about. But also the margins in the other parts of the business are performing well. Again, we've got some great performance in our factories where costs are going down. We're getting some modest price increases like we get every year.

And our expense base is -- given the low growth is flattish because our sales incentives, rather than accruing at a growth rate in the double digits we're accruing at a growth rate in the single digits. So our expense base looks pretty favorable versus last year. All of that with, again, improving sales trends that that Pat mentioned should give us I'll say the more seasonality in the margins that we've experienced in the past.

Again, generally in [34 or 35] is with the growth would be -- I'll say my expectation looking forward to the next couple of quarters.

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

Okay, that's interesting, then. If you're not saying that there was something unique here in terms of mix or lower input costs or anything like that, it was just good solid factory performance and a good incentive cost structure.

Jim Graner - *Graco Inc. - CFO*

Exactly, yes.

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

Okay. Shifting over to Contractor, again, another margin question, but with the big step up we saw year-over-year there, and that it sounds like it's not being driven by big change in your mix that we're hoping to see at some point, just again good factory performance and volume leverage. Any reason why that wouldn't continue to be higher in the next two quarters as we get into the seasonally strong part of the year before Q4?

Jim Graner - *Graco Inc. - CFO*

Yes, it's -- I think your conclusions are exactly where management is at. We saw about a 400 basis point improvement. As you know, second quarter is generally the highest volume quarter.

With that expectation, again, we would expect around a 400 basis point improvement again in the second quarter over where we were last year, which would get you closer to the 25%. We would expect that to probably be the peak on a quarterly basis for the year, again, with volume dropping off in the third and fourth quarter on normal seasonality of that business.

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

Got it. Just one more for me, shifting over to M&A. Has your pipeline of potential candidates shrunk at all following this ITW experience?

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

Actually, from a Graco standpoint, our pipeline is broader than it's been. And it's really more of a reflection of the fact that we've got more resources that are out exploring interesting end markets and interesting product technologies to us.

So, historically we haven't been very acquisitive and we haven't put a lot of resources into it. The last few years we have. So I think really regardless of what's happening out there in the overall M&A market or specific to anything happening with the government on ITW, we are in better shape there than we have been. And I'm optimistic as to what are opportunities in the next few years are going to be.

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

Okay, thank you.

Operator

Liam Burke, Janney Montgomery Scott.

Liam Burke - *Janney Montgomery Scott - Analyst*

Thank you, good morning Pat, good morning Jim. Pat, on powder coatings, have you been able to pick up any additional distribution on the -- in any of the regions now that you've incorporated Powder into the Graco distribution network?

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

You know, I'm not sure I can speak exactly to distributor -- the number of distributors. But I can tell you there's activity in all regions. We've got pretty good cooperation happening between legacy Graco, wet finishing leadership and the leadership of the powder in the regions.

And they have been, of course the last 6 to 9 months, working on various analyses of coverage, both distribution and direct as well as end-user opportunities. And so I'm satisfied with the direction that's going. The actual number of distributors, I don't have.

Liam Burke - *Janney Montgomery Scott - Analyst*

Okay, and on the Lubrication side, how did the Industrial Lubrication business is it performing to your satisfaction? It had been moving along pretty nicely for a while.

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

It was a tough quarter for Industrial Lube. Industrial Lube business outside of the mining accounts in Asia was okay. But here in the US the Industrial Lube business was down a little bit, and pretty reflective of what we're seeing in the industrial end market.

So it was not a good quarter for the Industrial Lube business. We're launching some nice new products and I'm happy with the team. So I'm not negative about it over the longer term, but it wasn't a good first quarter.

Liam Burke - *Janney Montgomery Scott - Analyst*

Great, thank you.

Operator

Matt Summerville, KeyBanc.

Matt Summerville - *KeyBanc Capital Markets - Analyst*

A couple of questions. Jim, in answer to a question earlier, I just want to make sure I understand. Did you say that April has tailed off relative to March in the Industrial business? Did I understand you correctly?

Jim Graner - *Graco Inc. - CFO*

That's correct. Again, it was more along the averages of the first quarter.

Matt Summerville - *KeyBanc Capital Markets - Analyst*

Okay.

Jim Graner - *Graco Inc. - CFO*

March was slightly better than January and February. You have to recognize, of course, we do get some project kinds of business. The weekly (multiple speakers) are not really indicative of (inaudible).

Matt Summerville - *KeyBanc Capital Markets - Analyst*

Okay, and then can you talk a little bit about sell-in versus sellthrough in the home center and professional paint channels? Are you seeing your customers there build inventories kind of above and beyond what you would expect from seasonal standpoint?

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

Yes, I don't think inventory build had that much impact for us on the quarter. Sellthrough has been good; sell-in has been good. So I think it's just more reflective of the market that is absolutely improving out there, and I think more optimism by the contractors.

The end-user shows that are hot and heavy at this time of year, the feedback from the field has been good. And contractors are positive about their book of business. We're seeing, of course, construction pick up, and pretty substantially in a number of regions. So I think really what you're seeing is reflective of the end market and not really any dramatic shift one way or the other in inventory stocking.

Matt Summerville - *KeyBanc Capital Markets - Analyst*

And Pat, is there any kind of more granular detail that you can give on end market trends in North America? I know you said things seemed to be broad-based. But if you think about some of the bigger buckets in that business, construction related, automotive related, can you talk a little bit more real-time there what you're seeing specifically?

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

Yes, that little bit tough you know, on a quarter, because again, we sell through distribution. Our distributors cover lots of end market. So it's not like I can press unbuttoning get a report that tells me exactly what end market is doing what.

We've been through our operating reviews here with our traditional groups in the first quarter. And really, the kind of difference is that we're not hearing from our team that the factories in North America are slow. So the factories seem to be running, people seem to be producing product.

But what we are hearing is that they're concerned and that they're being cautious on capital spending. So, you know, we're quoting jobs but they're just not coming through with the velocity that we saw last year. And that's what concerns me.

I've looked at a lot of the company said it been reporting here in the last couple of weeks. And this sort of flat organic growth on the industrial side has been fairly typical, and with flat organic growth, of course, factory managers worry about CapEx spending. So, from my view, that's one of the issues.

Matt Summerville - *KeyBanc Capital Markets - Analyst*

On the new equipment side, if things are comparably softer, you've seen, than things are a little bit more healthy from a spare parts/aftermarket component of North American Industrial?

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

That tends to stay pretty stable for us. So I can't say there's been a big shift. It's not like our equipment sales have crashed. It's just we expected to have a little bit more growth than we had here in the first quarter.

Matt Summerville - *KeyBanc Capital Markets - Analyst*

Understood, thanks guys.

Operator

(Operator Instructions) Jim Krapfel, Morningstar.

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Jim Krapfel - *Morningstar - Analyst*

Thank you, good morning. Can you speak about the opportunities you see for industrial applications longer-term in your Lubrication segment? And can you remind us what percentage is industrial within Lubrication by region?

Jim Graner - *Graco Inc. - CFO*

Let's say, I'll take a shot at it. Maybe I can get some help here with the exact numbers. Our market share in Industrial Lube is sub-5% sort of a global market share.

We entered that space with a couple of small acquisitions in 2006, 2008, which got us a toehold in the market. And our efforts since then have been to really build that product line and try to get -- it's a very broad product line, much like Graco's non-lube Industrial business. You have to have lots a lot of products to compete in that space.

What we're doing on a systematic basis is going across the product line and trying to differentiate our new products from what's available and the marketplace. So it's an entrenched market. The competitors that are there have been there for 100 years.

We think that we can win with our new product technology, but it's not going to happen fast. It's going to be that proverbial three yards and a cloud of dust. I like some of the new products we've got launched, and I'm expecting that that business for quite some time should give us pretty consistent double-digit growth every year.

Jim Krapfel - *Morningstar - Analyst*

Okay. And do you have a certain market share in mind like longer-term, or growing at double or three times by a certain timeframe?

Jim Graner - *Graco Inc. - CFO*

No, not really. Haven't set a long-term market share target, but I do believe we should be seeing that business -- obviously if there's a big crash we're not going to, maybe, in that particular year. But that business ought to grow nice double-digit topline. What that number is I don't really know.

Jim Krapfel - *Morningstar - Analyst*

Okay and then second --

Jim Graner - *Graco Inc. - CFO*

Maybe Caroline can answer your questions on the split.

Jim Krapfel - *Morningstar - Analyst*

Okay, sure.

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

Yes, we're thinking that the Industrial Lube business 26%, 27% of the business overall. And a good chunk of that is in North America.

Jim Krapfel - *Morningstar - Analyst*

Okay, and a second question is the 32% to 33% tax rate still an appropriate tax rate to use for 2014 and beyond?

Christian Rothe - *Graco Inc. - VP, Treasurer*

It's going to be a -- I'm sorry, for 2014 and beyond I think we are going to be more in the 32% range.

Jim Krapfel - *Morningstar - Analyst*

32% range, okay thank you.

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

So we are affected by the dividends from Liquid Finishing. So depending on how that plays out, depends on how many quarters we have that effect.

Jim Krapfel - *Morningstar - Analyst*

Okay, great. Thank you.

Operator

If there are no further questions, I'll turn the conference over to Pat McHale.

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

All right, thank you very much, and we'll look forward to talking to you again in three months.

Operator

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