Company: **GRACO INC. (ACT)**

Conference Title: **3rd Quarter 2017 Earnings Call**

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Moderator: **Pam Steinkraus**

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Operator: Good morning and welcome to the Third Quarter 2017 conference call for Graco Inc.

If you wish to access the replay for this call, you may do so by dialing 1-888-203-1112 within the United States or Canada. The dial-in number for international callers is 719-457-0820.

The Conference ID Number is 9177064.

The replay will be available through October 30, 2017.

Graco Inc. has additional information available in a PowerPoint slide presentation, which is available as part of the webcast player.

At the request of the company, we will open the conference up for questions and answers after the opening remarks from management.

During this call, various remarks may be made by management about their expectations, plans and prospects for the future. These remarks constitute forward-looking statements for the purposes of the Safe Harbor Provisions of the Private Securities Litigation Reform Act.

Actual results may differ materially those indicated as a result of various risk factors including those identified in Item 1A of the company's 2016 Annual Report on Form 10-K and then Item 1A of the company's most recent Quarterly Report on Form 10-Q. These reports are available on the company's web site at www.graco.com and the SEC's web site 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.

As a reminder, today's conference is being recorded.

I will now turn the conference over to Caroline Chambers, Vice President Corporate Controller and Information Systems. Please go ahead.

Caroline Chambers: Good morning everyone. I'm here this morning with Pat McHale and Christian Rothe. Our conference call slides are on our web site and provide additional information on our quarter.

We saw strong growth in all segments and regions in the third quarter and sales totaled $380 million, an increase of 16% from the quarter last year. Net earnings as reported totaled $75 million or $1.30 per diluted share.

On an adjusted basis, net earnings totaled $67 million or $1.15 per diluted share with an adjustment of 6 cents related to the excess tax benefit from option exercises this quarter and 9 cents related to a tax planning benefit that will not recur in 2018.

We're presenting earnings with these adjustments to provide consistent comparability quarter-over-quarter and a reconciliation from GAAP income is included on page 18 of our slide deck.

Foreign currency translation was slightly favorable this quarter as compared to last year increasing sales by $3 million and net earnings by approximately $1 million. Our third quarter gross margin rate decreased slightly as compared to this quarter last year.

Favorable realized pricing, product cost management and currency were offset by unfavorable product mix including a higher mix of project-based sales this quarter. While we anticipate modest commodity cost pressure during the fourth quarter, we also expect cost reduction activities and continued strong factory volumes to offset these increases.

Operating expenses this quarter were higher than last year primarily due to increased accruals for variable incentive plans related to sales and earnings growth, market-based stock compensation plans and pension costs. These volume and rate related increases were partially offset by $1 million lower amortization expense.

As noted in earlier quarters the lower amortization is related to the impairment recognized during the Fourth Quarter of 2016.

Third quarter operating expense as a percentage of sales was 27% as compared to 29% in the prior year. With the strong sales volume and expense leverage operating earnings in the third quarter grew by $18 million or 22% compared to the prior year.

A reconciliation of our operating earnings is included on page 6 of our slide deck.

The as reported tax rate for the quarter was 22% including the excess tax benefit from the option exercises of $3 million and $5.5 million related to a tax planning benefit that will not recur in 2018. The adjusted tax rate is 31%. Excluding any effects from stock option exercises, the fourth quarter tax rate is expected to be 28% with a benefit from tax planning of approximately $2 million that will not recur in 2018.

Year-to-date cash flows from operations totaled $246 million and changes in working capital are in line with volume growth.

Year-to-date capital expenditures totaled $29 million and we expect CAPEX for the full year to be approximately $40 million.

We have a number of manufacturing and distribution locations that are nearing capacity and we are beginning to plan some brick and mortar projects. We've also paid $60 million in dividends to date this year.

We made a contribution of $20 million to the U.S. pension plan during the third quarter. We also approved a plan during the third quarter to purchase insurance contracts to settle a portion of the U.S. pension liability, which will result in a settlement loss that will be recognized during the fourth quarter. The settlement loss is estimated to be in the range of 11 to $13 million and will be an item that we will consider in our calculation of adjusted net income during the fourth quarter.

Excluding the effects of fourth quarter pension settlement, unallocated corporate expenses are expected to be $32 million for the full year slightly higher than previously estimated due to higher stock compensation expense.

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

Pat McHale: Thanks Caroline and good morning everyone. All of my comments this morning are on organic constant currency basis. For the third consecutive quarter, we had growth in every segment and in every region of the world with solid contributions from both developed and emerging economies.

Like the first three quarters of the year, performance beat our own expectations. Demand was broad-based and profitability was strong. I'll focus my comments on a few of the areas that I think are notable.

With the exception of the Process Segment in EMEA where we continue to face challenging offshore oil and gas market we posted double digit growth in every segment within every region in the third quarter. Project activity was good in industrial particularly in the Asia-Pacific Region, which posted a tenth consecutive quarter of growth. In total, our Asia-Pacific Team has had one heck of a year.

Contractor Americas continue to see good demand from the home center and paint store channels with out the door sales solid for both in the quarter.

The Worldwide Contractor Team has really performed. And notably our EMEA Contractor Team posted another double-digit growth quarter and has had I think a great year on top of last year's great year.

Our Oil and Natural Gas Operations were down in the third quarter year-over-year but posted modest growth sequentially. Growth in North America was more than offset by declines in the EMEA Region where we have more offshore exposure. It's a small part of our business and at current oil prices, we're not looking for significant contributions in the near term.

Moving onto profitability, incremental margins were in the low to mid-30s a bit lower than the high 30s to low 40s we expect over the cycle. Our continued strong financial performance during 2017 is resulting in increased expense provisions for growth related rebates and incentives putting temporary pressure on our flow through margins.

As a reminder, Graco Incentive Programs generally reward growth over prior year. Strong growth results in higher incentive expense in the year earned. But the bar is reset the following year at the new higher level. We like this formula and think it's a win-win for our people and for our shareholders.

Additionally, as Caroline mentioned we had unfavorable mix, which dampened gross margins a bit during the quarter. Price costs remained favorable. Our factories are running very efficiently and expenses outside of growth related rebates and incentives are levering nicely. Overall, I think we're in good shape.

Moving onto our outlook, incoming order rates were strong every month of the quarter I every region. Orders for the first three weeks of October, continues to be solid. Our fourth quarter comparable is our most difficult of 2017. Notably in Q4 of 2016, we had an additional week, 14 weeks last year but only 13 weeks this year. The math alone creates a significant comp issue for us in the coming quarter.

Also you may recall that last year our contractor business had a huge Q4 with 17% top line growth and a nearly 30% increase in operating earnings. Although we expect to report low single digit organic growth in the fourth quarter I would view that as in line with our 2017 year-to-date performance and that would give us a shot at finishing the year with double-digit top line organic growth.

I do expect some profitability headwinds in Q4 as we should see continued expenses related to growth-based annual rebates and incentives, which as I mentioned will reset in 2018. We're also pushing hard to get geared up to hit the ground running with new products and programs in January and will likely have some spending in Q4 to support that particularly in our contractor business.

We are expecting the business environment to remain strong as we enter 2018 and look forward to giving you our formal outlook on our Q4 conference call at the end of January.

Operator we're ready for questions.

Operator: Thank you. Ladies and gentlemen, if you would like to ask a question at this time, please press star and then 1 on your touch-tone telephone. If you happen to be on a speakerphone today, please pick up your handset or depress the mute function so the signal can reach our equipment, again that is star and then 1, if you'd like to ask a question. We will take our first question from Joe Ritchie with Goldman Sachs.

Evelyn Chow: Hi. Good morning. This is Evelyn Chow in for Joe.

Pat McHale: Good morning.

Evelyn Chow: You know maybe I'd like to start. I think on your slides you noted you expect the positive business environment to continue into 2018. Obviously you've had incredible performance this year, year-to-date.

I'd just like to understand maybe a little bit better what you're seeing in your planning environment, your customer conversations or your order funnel to kind of support that comment.

Pat McHale: Yes. I'd say generally most end markets are looking up. Certainly most of the end markets in EMEA are stronger than they have been and the trends there are good.

We're seeing our businesses around commodities like mining improving. And that touches in several different business segments that we have. We expect oil and gas continue to be tough but automotive and construction to continue to be pretty good on a worldwide basis.

So, you know, while it's not – I wouldn't call it booming. Our results are good. But I wouldn't say business is booming. I think that trends are looking positive across most markets globally.

Evelyn Chow: That's very helpful and then maybe turning specifically to process for a second. Just want to understand. You've had really good incrementals thus far in the year. I think 3Q maybe it took a slight step down.

Would it be your expectation that those incrementals normalize back to prior level?

Christian Rothe: Yes. Evelyn this is Christian. I think those incrementals in the first half were a little bit hotter than what we had expected and the third quarter maybe was a little bit more disappointing. So it's probably going to moderate somewhere in between.

Operator: Does that answer your question?

Evelyn Chow: Thank you very much.

Operator: Okay. We'll take our next question from Josh Pokrzywinski with Wolfe Research.

Josh Pokrzywinski: Hi. Good morning guys.

Pat McHale: Good morning.

Josh Pokrzywinski: So I guess if you were having internal bets on who was going to ask about a hurricane first, the winner is the second question.

On the contractor side I would imagine with a few storms over the last couple decades that have names people remember, you know, how should we think about the uptake in the rebuild process? Is that a quarter or two delayed? Does that tend to be high mix, low mix? Just kind of walk us through how that looks in the rebuild process.

Pat McHale: So the one thing I would say is that I've had a personal goal in my ten years plus as CEO to never talk about the weather. There's always something happening somewhere in the world. And we're a really global organization and our sales come from all over. So the impacts of what happens in one particular city or one particular state at any given time really shouldn't be something that I think we need to talk about in terms of overall impact.

Obviously the equipment that we have would be used in areas where there's a disaster when the rebuilding process is far enough along that they're starting to apply things like mortars and paint.

Josh Pokrzywinski: Got you. So maybe a little bit on a delay from kind of the initial, you know, quarter after.

Christian Rothe: Your words, not Pat's. I'm also excluded from talking about the weather.

Josh Pokrzywinski: Okay fair enough. Moving on I guess from the weather as we see kind of a broader industrial shift from, you know, maybe small MRO type spending to a bit more on the project side even if it's small project. Can you talk about how that, you know, impacts your business from, you know, from a product mix either favorably, unfavorably versus what we've seen the past couple quarters? Is that a net positive? Is it a net negative on mix because there's less aftermarket relative? Just trying to understand, you know some of the sensitivity there and maybe the answer is, you know, there is but not much.

Christian Rothe: Yes. So this is Christian. The – with regard to larger project activity like for example we saw in the third quarter, we did see some project activity that had a little bit unfavorable mix for us and a little bit of headwind on the incrementals when we looked at the third quarter. Broadly speaking though over, you know, a number of quarters after the project's done, that tends to normalize.

So, you know, the project activity can have a little bit of an impact in the initial quarters but again over time it tends to be not a huge impact.

Josh Pokrzywinski: Got it. Thanks for the color Christian. I'll pass it on.

Operator: And we'll take our next question from Charley Brady with SunTrust Robinson Humphrey.

Charley Brady: Morning guys. Can – your commentary on the adding brick and mortar, obviously something you guys hadn't done in a long time. You've got pretty concentrated manufacturing.

Would you guys continue to stay in that area or, you know, branch out beyond that? And I'm just also wondering locally would that push you out into internationally?

Pat McHale: So our strategy hasn't changed. And although our footprint will get bigger we're not making a concerted effort to move anything. We just have facilities that we already have operating at Graco that are full.

And work that we're going to be doing is going to be expansion of our existing footprint, not trying to move to a new location or pursue some other new manufacturing strategy.

Charley Brady: Okay. Would you imagine that gets done in '18 or is it too early to kind of call the timing on that?

Pat McHale: There is different size projects. There may be some things that get done in '18. I would anticipate probably you'd see more of the impact in '19.

Charley Brady: Okay great. And then just on the contractor business, I know you commented out the door sales of both home center and pro we're good. But can you drill down a little bit more on kind of how the out the door sales looked?

Pat McHale: Yes. No, I mean I'm not going to give you more granularity than that. But both of them were very solid.

Charley Brady: How about the mix within contractor, kind of the, you know, the low, medium, high? Has that moved, you know, anything in the past 12 months or is it still, you know, kind of the mix a little bit different than it was the last peak where you had a greater mix of high margin stuff?

Pat McHale: Yes. So you'll recall the last peak our home center business wasn't near as big as it is today. And in fact we continue to expand our home center business in the new channel partners overseas.

So and I think it's hard to compare back to the 2007 peak any more when you take a look at that. Home centers obviously are selling to a different customer base and generally sell the smaller units where you've got a bigger mix in the propane channel.

Charley Brady: Fair enough. Thanks.

Operator: Our next question comes from Jeff Hammond with KeyBanc.

Jeff Hammond: Hey good morning guys.

Pat McHale: Good morning.

Jeff Hammond: Hey so industrial and contractor, you know, seeing really nice outsize growth. Clearly, you know, a lot of companies are talking about better markets.

But can you try to differentiate what you think is market acceleration versus new product traction and where in terms of new products are areas where you think you're having the most success?

Pat McHale: Yes. So it's difficult. You know there really aren't any market share kinds of data points available for us out there. We continue just to do what we do. You know we expand distribution into new geographies. When we see opportunities, we're launching new products out of all of our divisions on a regular basis. I would say that our new product launches in 2017 were probably similar to what you've seen in prior year contractor with a very nice line-up as they normally have and good success with those products and selective Industrial and Process Segment products that also contributed.

You know it's - obviously we haven't done a good job of looking forward and seeing what sort of revenue that we were going to drive quarter-to-quarter. We've been kind of chasing it since the beginning of the year.

And it's not all together clear what is driving it. But we're going to continue to do what we do and we're going to get hopefully continued good Graco results.

Jeff Hammond: Okay and then Asia, it seems like most of the colors on the end market charts are still yellow. Yet the growth is high teens. Is that, you know, you don't like the color green or is it that, you know, you're really being driven by share gains? Just help me understand that a little bit better.

Pat McHale: Yes. I think, you know, so there does seem maybe a disconnect between what we view as some of the market situations and our actual performance right now. I mean we've been performing very well in the Americas as the America is a double digit organic growth market as I think we think not. Our performance is but I think we think not.

So we're really trying to be reflective of not just our own performance but what we view the end market as. And frankly we're a conservative organization. And sometimes we laugh. We don't know how good it would have to get before all the dots would be green. It must have to be really, really good.

Jeff Hammond: Okay thanks Pat.

Operator: Our next question comes from Saree Boroditsky with Deutsche Bank.

Saree Boroditsky: Hi. Good morning. I wonder if you could talk some about your focus on automation solutions in industrial and what you're seeing from a demand perspective both regionally and by end market.

Pat McHale: Yes. So I mean that's a very positive trend for us. And we've done a fair amount with our product development plans over the course of the last five or six years to try to make sure that the new products that we've got in the pipeline are in line with the trends in automation that we're seeing in industrial. Those trends, you know, started a number of years ago to be pretty visible and impactful in high wage geographies but really over the last few years we've seen that expand into really all regions of the world.

And I think people are looking at automation from a quality standpoint and it's obviously a nice opportunity for us to sell equipment that integrates tightly with automated solutions and we continue to pursue that.

Saree Boroditsky: Great, thanks. And sticking on industrial, maybe you can talk a little bit about what's going on in industrials America and the heavy equipment. I believe it's been challenging for you guys starting in 2013 but we're starting to hear some positive commentary from some of the OEMs. So maybe just what you're seeing in that market.

Pat McHale: Yes. I mean obviously if you've looked at some of the releases that have come out here just this quarter, there's been a nice uptick in some of the heavy equipment manufacturers.

And we view that as being very positive. Those generally tend to be good customers of ours and when they're doing well they invest in their facilities so like that dynamic.

And we got some exposure in many of our business units to mining on a worldwide basis. And mining was really pretty dead for a while. Now with commodity prices ticking up we see activity in the mines. It's driving business for us.

So and outside of oil and gas, we think that direction with commodity inflation is positive for us and it's going to continue to be as we go forward into 2018.

Saree Boroditsky: Great, thank you. I'll get back in queue.

Operator: We'll take our next question from Matt Summerville with Alembic Global Advisors.

Matt Summerville: Thanks. Just a couple questions, if you look back over the last few years, you've typically seen a seasonal dip overall in your business from Q2 to Q3 particularly in contractor. You didn't seem to see that at all. Your revenue in total was flat sequentially, contractor only down slightly.

So can you talk about the seasonal dynamics you're seeing in the business, what's changed? Maybe it's what's going on on the project side. But if you could definitely include some comments on contractor, that'd be helpful.

Pat McHale: Yes. I probably wouldn't jump to any conclusions based upon this year's Q3 that kind of the normal cycle is going to be different. We can have noise quarter-to-quarter. There's nothing really that stands out for me that was unusual in Q3.

But, you know, I think generally speaking people are going to paint in the northern latitudes more during good painting months and they're going to be buying equipment in advance of that. Distributors are going to be loading up in advance of that.

So, you know if I was a guessing person I would be guessing that over the course of the next few years the cycle would end up looking more normal and that nothing has really changed.

Matt Summerville: And then just back on the project side of things, this is the first quarter in a while I think you at least called it out in the press release, called it out in your prepared remarks. Have you seen a definitive step function improvement do you think in project activity? Are the projects you're seeing related to capacity expansion or more debottlenecking, upgrading existing manufacturing facilities?

And I guess, you know, to that point, should we continue to see or are you suggesting that we should continue to see incrementals a bit suppressed for the next couple of quarters at this point?

Pat McHale: So when I take a look at where the heavy project activity has been coming from, there's more than one dynamic at play.

And I certainly think the fact that people have a positive outlook on business and are willing to spend some money is kind of a macro theme that helps move things along. But we got project activity that's been driven by people making decisions on materials that they're going to use so maybe switching from one material to another will drive project activity. We've seen some of that.

We've seen some project activity that's been driven by our own initiatives trying to enter into new market spaces that tend to be more heavily focused on projects.

And we've seen projects particularly I've noticed quite a few in the North America dealership business that we talked about a year ago that just never were let loose that have been let loose here in 2017.

So it's a little bit of a mixed bag. But I think, you know, overlying all of the different reasons that we see for projects is the fact that optimism is there and business trends do seem to be going the right direction.

Matt Summerville: Thanks Pat.

Operator: And we have a question from Mike Halloran with Robert W. Baird.

Mike Halloran: Good morning.

Pat McHale: Good morning.

Mike Halloran: Could you talk about the price cost curve both in terms of what you're seeing on the commodity inflation side and but more broadly your thoughts on labor, supply chain and other types of pressures as you're working through '17 and into next year?

Caroline Chambers: Well basically what we're seeing is that when indeed some of the commodities are starting to kick in then we see a little bit of those costs increases on our product side. But we also have a lot of factory projects that go on. And we're seeing efficiencies coming through there as well as our factories running at nice volume levels at the moment.

Pat McHale: And you'll recall Mike that my view is that rising commodity costs is a net positive for Graco. You know I don't think you could look back a couple decades and find us spending much time talking about the fact that we had some earning surprise because of commodity cost. It does put some pressure on us. But we've got strong gross margins and we've got great factory people that are working hard to offset those.

And other side of that coin is when commodity prices are rising we have key customers that are doing well and they're investing. And I think that we make it up on the backside.

So if you gave me a choice of a rising commodity environment or a sliding commodity environment, I'd pick rising any day of the week.

Mike Halloran: But beyond commodities though it doesn't sound like you – it sounds like you feel you're more than on top of the inflation pressures there to, right?

Pat McHale: In terms of labor and logistics and things.

Mike Halloran: Yes.

Pat McHale: Yes. No. I think we've got, you know, we got good processes at Graco for measuring and managing our costs. And those processes remain in place. And it's not easy any year. Certainly it helps when we have volume but the team continues to execute. And I believe we will going forward.

Mike Halloran: Great, appreciate it. Thanks.

Operator: Our next question comes from Deane Dray with RBC Capital Markets.

Deane Dray: Thank you. Good morning everyone.

Pat McHale: Good morning.

Deane Dray: Hey. I might have missed it. But did you size the impact of the growth rebate and investments in the quarter? And similarly, what should we be looking at for the fourth quarter?

Christian Rothe: Hey Deane, it's Christian. Yes. If you look at our slide deck on slide 6 we do call out on the change in operating earning slide that volume and earnings-based incentives were up $4 million year-over-year, which was a 1 percentage point headwind on our overall operating margins.

Deane Dray: Got it. And then I know this is a high quality problem. But under capital allocation how are you thinking about deploying capital with what is looking like an increasingly under levered balance sheet?

Pat McHale: Yes. So we are going to continue to do what we've done I think historically. We're going to invest back in the business and all of our growth initiatives. And beyond that we're going to be looking at M&A opportunities. But we're going to look at them with discipline. You know prices are high and we need to make sure that we can get a good ROI before we just go out and buy something.

We've got the dividend that we consider with our Board. And then in terms of share buybacks, we're going to be opportunistic. And we'll make a decision after looking at the other options as to what we want to do.

So I don't think our strategy has changed. Certainly we are generating some cash right now. And have not been aggressively buying back stock.

But, you know, at any given point in time something could happen on the M&A front that would change the picture. So I don't feel like we've got any eminent pressure to do anything. And we're going to just kind of hang tight here and let things roll.

Deane Dray: Great. And just last question from me, a lot of discussion about contractor and just broadly your distribution channel partners. Do you have any sense on the uptick in organic growth that you're seeing? Is there any difference between what might be the sell in to your distributors versus their sell through? Any color there would be helpful.

Pat McHale: Yes. I'm not – I don't see that as being a significant factor for us. I think that both out the door sales and the sell in have been reasonably aligned with our major channel partners as we went through the last - even longer than 2017.

There may be some dynamic in the marketplace out there regarding less people doing their own painting and more people hiring painters. There was an article in the Wall Street Journal. And I've heard some commentary from some of our channel partners and some of our field personnel along that line. That could be a positive dynamic.

But it's really, really hard for us to get our arms around. But I don't think it's an inventory build.

Deane Dray: Great. Thank you.

Operator: And we'll take our next question from Brett Kearney with Gabelli & Company.

Brett Kearney: Hi guys. Good morning. Thanks for taking my question.

Pat McHale: Brett, good morning.

Brett Kearney: Just want to ask, I guess provides a lot of color on the slide deck. I got a sense for kind of what's going on in the Asia-Pacific market.

Just want to ask kind of outside of Asia what you guys are seeing in terms of emerging market regions you operate in and your outlook for those regions going forward.

Pat McHale: Yes. That's been a positive story for us this year taking a look at our revenue or our order – incoming order rate. Let's, you know, move over to Africa and Middle East and Eastern Europe. And they've been participating nicely in terms of the rebound that we've been seeing in our EMEA business so and emerging markets seem to be on the mend.

I would say that, you know, Russia is getting better but they're getting better slowly. And if you take a look at forecasted GDP for Russia going forward, I think it's in that 1.6 kind of range so a slight uptick from where they were at but certainly moving in the right direction. And that's good business for us in the East.

Africa relies a lot on extraction and with the improvement in commodities, we're expecting that improvements in our business opportunities in Africa are going to continue to get a little bit better. Certainly if oil prices would add another 10 bucks, I think that would be significant in places like both Russia and Africa.

But we'll take what we got in terms of the mining piece. And we'll do the best we can with that.

Brett Kearney: Great, thank you.

Operator: And we'll take our next question from Walter Liptak with Seaport Global Securities.

Walter Liptak: All right thanks. Good morning.

Pat McHale: Good morning.

Walter Liptak: Just wanted to ask a couple of follow-ons on the projects that you're talking about. And I'm wondering if, you know, what your thoughts are on, you know, kind of turns business versus project work. You know, do you get better visibility out of the projects work? Is pricing better on projects? And, you know, can you get visibility going into 2018 because of it?

Pat McHale: So we get a little more visibility out of project work. And, you know, keep in mind it's still a small percentage of our overall business. It just can move things around quarter-to-quarter. But it's not like Graco's business is dramatically changed on the project front.

So yes, we do get some visibility there. I don't think it helps a lot with our overall revenue visibility.

In terms of margins, the biggest thing with project activity is in projects we end up frequently selling a lot of non-Graco manufactured content. And when we've got some non-Graco manufactured content in a systems or project sale, that's just naturally going to take down the overall margin.

Generally the Graco components of a system we get our margin on. And generally the pass through kind of stuff we get more like pass through margins. So that's really the biggest impact there.

Walter Liptak: Okay. Okay and if I can just ask a couple on industrial Americas, you know, construction markets, you know we've seen data that's showing, you know, a bit of a slowdown in construction markets. But you're showing it as favorable.

You know is it – you know is, you know, are construction markets painting things instead of like rebuilding or building and, you know, what are your expectations for that construction market?

Pat McHale: You know so we really look at the overall general level of activity. And when the contractors have jobs lined up, they'll buy equipment.

And when you think about what the cost is for a contractor doing a job in North America obviously the paint and the labor are their big expenses and equipment tends to be a smaller expense. If they don't have jobs lined up, then they're not buying equipment. If they have jobs lined up, then they're typically buying equipment.

And so, you know, we view the current level of construction activity out there in the market to be favorable for us. I have seen some of the same data that you're talking about, some discussion about nonres slowing down.

But generally what we hear from contractors is that they've got work.

Walter Liptak: Okay. So this would be build out of office building, things like that.

Pat McHale: I'm sorry. Can you say that again?

Walter Liptak: In other words – oh that would be the – that would be build out of office space.

Pat McHale: It's everything.

Walter Liptak: Oh.

Pat McHale: I mean if you think about what paint goes on, it's new construction, it's refurbishment, it's exterior, it's interior office. I mean it's and we sell through distribution. And we don't know what a paint sprayer is used for after we sell it. It could be the same sprayer can be used to paint a church or a house.

Walter Liptak: Okay great. And then automotive, I think you commented that North American dealership was up. I wonder if you could go into that a little bit and, you know, what you're seeing from the auto sector because that sector may have peaked a little bit for production.

Pat McHale: Yes. So what we've seen is and that's really more of a comment along some of the project business. We had a number of projects at dealerships that did not – that were in the – slated for 2016 but then they never let the order. And we saw a lot of those orders start to get let here in 2017.

So just our view is that at least from a car dealer perspective it seems like they've been more active investing back into their dealerships.

Walter Liptak: Okay. And then the Tier 1, you know, is it – you showed it's stable. You know is there –I imagine those are projects as well. Is there visibility there?

Pat McHale: You know in North America there tend not to be a lot of new car plants get built. And generally our business in North America when you talk about the OEMs and then down to the Tier 1s tends to be based upon new models, new materials, things like that.

So there's been enough activity. I mean I'm not going to say it's great. You've seen the numbers on car sales. And they do appear that they have peaked. But certainly activity levels are still good.

And people are still looking for cost reduction and energy savings and changing processes and launching new model years. So we're active in all those.

Walter Liptak: Okay. Thanks for taking my questions.

Operator: And we'll take our next question from Jim Giannakouros with Oppenheimer.

Jim Giannakouros: Hey good morning everyone.

Pat McHale: Good morning.

Jim Giannakouros: On contractor margin, this is something that we talked about several quarters ago. But I don't think we've heard an update on, you know, high – your more highly engineered. You're higher margin, maybe more of a system sale if you will in contractor. That product category or call it just that area, I remember it being framed as something to the tune of $100 million below peak.

And, you know, we were waiting for increased investment there or sales there to help the margin progression.

Is that actually happening now as we're several years into an up cycle in construction here? Are contractors moving up in what they're actually buying from you guys?

Pat McHale: So I'm going to let Christian weigh-in in a second. But just to kind of clarify the product line, high-end of the contractor product line, they're not system sales. They're units that Graco builds just like the small units that are really 100% Graco and supplier content. And they just tend to be lower volume and higher output, higher capability kinds of equipment that carry a better margin for us.

But I'll let Christian talk a little bit about the trend that we've seen.

Christian Rothe: Yes sure. So Jim that data point about the $100 million goes back to - back really frankly to the 2011, 2012 kind of timeframe. And that was comparing back to our prior peak, which was really the '06 timeframe and talking about the fact that we were still missing a lot of sales and we were watching that gap.

Frankly that gap is not non-existent at this point. There was a little bit that we were still missing on the really high-end sprayers. For the most part that's dissipated now too.

So really, you know, especially if you look at the overall sales number, we're well past the prior peak number.

Jim Giannakouros: Got it. Okay thank you. And clarification point Pat on when you guys are doing a system sale, my impression was that you sell your Graco content and that you're not actually the ones that are doing the integrators – doing the integrating. Is that – did I get that wrong?

And if that is the case, I mean is that an opportunity where you're seeing, you know, as you get roped into, you know, more complex systems types of sales for you to take that on or are you just – or are you leaving that part to your channel partners?

Pat McHale: You can be confident that we don't get roped into doing anything. But so let me just kind of clarify because it really varies by business unit.

So if you take our for example, our liquid paint finishing for in plant applications, we've got a global network of distributors that have engineering capability. And we sell them Graco components and they do a lot of the technical work and they install. They buy whatever non-Graco components are needed. And they install systems at our customers.

If you take a look at the powder paint business that we bought a number of years ago as an acquisition, that's a direct sale model. And so when they do a project they sell the, I'll call it the core powder equipment but they also sell the booth, they sell the conveyor system, they sell the powder reclamation system. So that's a system sale with a lot of buyout content.

And nothing has really changed for us. Our distribution channel and our Graco legacy business continues to provide that capability and that support globally for our product lines.

But some of our more recent acquisitions have had a different selling model. And those have been driving some of our project sales.

In addition, we have a couple of new spaces that we're interested in where the business model is a little different and where the business model requires a direct sale. And we think it's interesting and we can make money at it. We've been pursuing that.

And none of those new initiatives are big enough that I'm talking about them at this point.

Jim Giannakouros: Got it. That's extremely helpful. Thank you. One last one and I apologize if I missed it. But in contractor, clearly Europe much did better than we thought.

You know what's accelerated there specifically? And I'm anchoring my thoughts on thinking that it happened in Western Europe specifically. Is it new construction, res, nonres, new products, if only by country? Any callouts there would be helpful.

Pat McHale: Yes. You know what it's been pretty broad-based. And we've seen good improvements in the East as well as the West. You know I don't have any – it's been a little bit mind boggling from my perspective too what they've done over there the last two years. I figured they were going to do well and they've done a great job with the new products, which have been pretty important.

But the kind of numbers that have been put up over there have been pretty spectacular. The only thing that I can mention specifically and I don't think that this is a huge driver but a big wave of immigration for example that came into Germany created the need for in Germany a lot of housing.

And so there would be one example of something that we can tie it to the fact that we're getting orders. But that doesn't really explain the strength of our business across EMEA.

Jim Giannakouros: Thanks Pat, helpful. That's all I had.

Pat McHale: Well the trend is better too I should mention. When their construction markets crashed around the same time ours did back in 2007, they didn't go through the pain in a very short period of time like we did. We pretty much sucked it up. Went through the pain and we got back on our horse.

And they really took the overhang in terms of units in places like Spain and France and they didn't just cut the price down to nothing and try to get that stuff moved to the marketplace. And so their, I'll say decline or their soft construction market instead of lasting, you know, three years like it did here was really more like a decade.

And we've seen that turn the corner over the course of last couple years. And while you look at their data in terms of construction activity and the numbers themselves aren't fantastic, the trend is clearly coming off the bottom. That also could be a really positive dynamic for us but again it's hard to measure.

Jim Giannakouros: Thank you.

Operator: And ladies and gentlemen just as a reminder that is star and then 1 if you'd like to ask a question today. We'll take our next question from Charley Brady from SunTrust Robinson Humphrey.

Charley Brady: Hey thanks. Just a quick follow-up on the commentary about adding some, you know additional investment back into the businesses because business is so good.

Can you just frame that in terms of from a margin perspective as we look at Q4 and, you know, tie this with the incrementals, you're still expecting margins would be up year-over-year despite some additional investment going into the businesses?

Pat McHale: I probably didn't do a very good job of answering the question clearly. What I was trying to communicate was is that our capital deployment strategy hasn't changed. And that we continue to look for opportunities to invest back in the business.

I wasn't trying to and I may have but I wasn't trying to indicate that we've got a bunch of new investments that we plan to put in. You know I would say our investments in our organic growth initiatives are going to be business as usual where we're going to continue to fund the ones that we have and as new ones pop up we will run the numbers on those and invest.

But I wasn't trying to announce that we've got some new level of spend on organic initiatives.

Charley Brady: Thanks. Appreciate that.

Pat McHale: Yes, sorry about it.

Operator: And we'll take a question from Liam Burke from FBR Capital Markets.

Liam Burke: Thank you. Good morning Pat. Good morning Christian.

Pat McHale: Morning.

Liam Burke: Pat could we go back to Western Europe? You mentioned stabilization. Obviously you touched on the contractor market but also in industrial.

If I'm look – if we're looking at pre/post-recession, where does Western Europe stand? Is there a ways to go or has it recovered from pre-recession levels?

Pat McHale: I guess everybody probably has their own opinion on that. My view on that is taking a look at the numbers is that they've got some significant upside left to harvest.

And that, you know, they - really if you look at car registrations, you look at construction data, you look at GDP numbers, they seem to be trending the right way. But certainly they're not at what I would consider robust levels at this point. But I think that the trend is good.

So I mean again if I'm betting, I'm betting it's going to get better before it gets worse.

Liam Burke: Okay. And then you mentioned new product introduction on the contractor side. Are you still getting the same type of new product flow from the other two segments?

Pat McHale: I would say that the other segments of the business are consistent in terms of their product output. And, you know, you don't get the big bang in the other businesses that you get in contractor really because of the nature of the product. Most of the customers want to test new products sometimes extensively before they accept them into their factories whereas contractors generally when you launch a new product, they'll just buy it and they'll go put it to work.

So I would say that things are pretty consistent as to where they've been in the past.

Liam Burke: Great. Thank you.

Operator: And there are no further questions in the queue. I would like to turn the call back over to Pat McHale for any closing remarks.

Pat McHale: All right, well thank you everyone for your time this morning. And we're going to get back to work and do the best we can to continue to deliver good results. Thank you.

Operator: Once again ladies and gentlemen that concludes today's conference. We appreciate your participation. You may now disconnect.