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EDITED TRANSCRIPT

GGG - Q3 2014 Graco Earnings Conference Call

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PRESENTATION

Editor

Operator: Good morning and welcome to the third quarter 2014 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 is 9078737.

The replay will be available through October 27, 2014. Graco has additional information available in a PowerPoint slide presentation, which is available as part of the web cast 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 from those indicated as a result of various risk factors, including those identified in the Item 1A of the Company's 2013 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.

As a reminder, today's conference is being recorded. I will now turn the conference over to Caroline Chambers, Vice President, Controller and Information Systems. Please go ahead, Ma'am.

Caroline Chambers: Good morning, everyone. I'm here this morning with Pat McHale and Christian Rothe. Jim Graner is on vacation today. I'll provide a brief, top level summary of our quarter and then we'll turn the call over to Pat for additional discussion. Our conference call slides are on our website and provide additional information on our quarter.

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Sales were $302.6 million (sic - see press release), an increase of 9% from the prior year. Sales from the recently acquired EcoQuip and QED businesses were $9 million, or 3 percentage points, of our overall growth.

Regionally, sales in the Americas grew by 12%. Sales in EMEA increased by 4%, or 3% at consistent translation rates. And sales in Asia Pacific increased by 7%, or 6% at consistent translation rates. Gross profit margins for the third quarter, as a percentage of sales, were 55%, up slightly from the prior year. Operating earnings, as a percentage of sales, increased 13% on the 9% increase in sales.

Operating expense increased by $6 million from the prior year, mostly due to expenses of acquired businesses and $3 million of incremental spending on regional and product growth initiatives. Acquisition transaction costs were about $500,000 in the third quarter.

Other income includes dividends of $9 million from the Liquid Finishing businesses, consistent with the third quarter of 2013. As announced in early October, the Federal Trade Commission has issued its final decision and order requiring the sale of the Liquid Finishing businesses.

Shortly thereafter, we also announced a definitive agreement to sell the Liquid Finishing business assets in a $590 million cash transaction. The transaction is expected to close no later than the first quarter of 2015, within the 180 days requirement from the FTC. The sale is subject to regulatory and other customary closing conditions.

Until the sale is closed, we will continue to account for the Liquid Finishing businesses held separate as a cost investment. We expect the dividends from Liquid Finishing businesses to be $4 million in the fourth quarter, consistent with the fourth quarter last year.

However, there are cash balances in the health of our businesses that may be distributed in the form of dividends or as a purchase price adjustment. Depending on the timing of the sales transaction close, additional dividends could be made in the fourth quarter.

When the sale of the Liquid Finishing businesses has been completed, there will be no further dividend income from this investment. Additional discussion of the Liquid Finishing businesses is included in our 2013 Form 10-K and in our third quarter 2014 Form 10-Q. The effective rate for the quarter was 28%, 4 percentage points higher than the prior year.

The increase resulted from the impact of the federal R and D tax credit that was not renewed for 2014, and additional benefit from US business credits in 2013. Net income totaled $60 million, or $0.97 per diluted share. Cash provided by operating activities was $86 million in the third quarter.

Use of working capital is in line with the volume and seasonal trends, and days of sales outstanding for accounts receivable remained consistent. In the quarter, capital expenditures were $8 million, dividends paid totaled $17 million and share repurchases, net of shares issued, totaled $44 million.

A few other discussion points. The cost related to our central warehouse initiative are expected to be in line with earlier guidance, which anticipated $2 million in the second half, about three-fourths of which will fall in the fourth quarter. Including the warehouse initiative, our corporate expenses are expected to be in line with the fourth quarter last year.

We expect capital expenditures to be approximately $30 million for the full year in 2014. The tax rate is expected to be approximately 30% to 31% for the fourth quarter and 29% for the year, excluding any impact from the sale of the Liquid Finishing business.

As noted earlier, we expect the dividends from Liquid Finishing to be formulated in the fourth quarter, the same as the fourth quarter last year, though this could be affected by timing of the sale transaction.

Transaction costs related to the sale are expected to total $11 to $13 million, most of which will be incurred when the transaction closes. I'll turn the call over to Pat now for further segment and regional discussion.

Pat McHale: Thanks, Caroline. Good morning, everyone. The third quarter was in line with our expectations and we're tracking nicely to perform to the second half outlook that we gave on this call one quarter ago. Q3 sales grew at a high single-digit pace with mid single-digit growth organically.

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For the second quarter in a row, we experienced growth in all reportable segments and regions. This is our 13th consecutive quarter of achieving record quarterly sales, a nice round that reflects a slow but steady improvement in the US economy, growth from acquisitions and great execution by Graco's employees worldwide.

Let's start our segment review by discussing Contractor. Our Contractor business posted 7% growth worldwide in the third quarter, earned by another double-digit year-over-year increase in the Americas. The double digit increase in the Americas was particularly good given it was up against an incredibly strong comp.

In Q2 -- excuse me, in Q3 2013, Contractor Americas grew 38%. Sales increases in the paint store channel were in the teens this quarter, while home center channel sales were flat. A big driver of the growth in Q3 of 2013 was from the home center channel, so I'm not concerned about being flat against that comp.

Outside the Americas, our Contractor business was down slightly versus the prior year. Year-to-date both the Asia Pacific and EMEA region have grown low single-digits. I expect both to finish in positive territory for the fourth and the full year. Moving on to Industrial.

Our worldwide Industrial segment posted low double-digit growth in the third quarter, consistent with the worldwide year-to-date growth rate. On an organic basis, the business achieved mid single-digit growth worldwide, led by strong double-digit performance in Asia Pacific.

In the Americas, our Industrial business slowed somewhat in third quarter, with organic growth in the low single-digits. Our backlog grew slightly during the quarter. And looking at order trends, I'm not overly concerned about underlying demand levels.

We do have our hardest comp of the year coming up in Q4 so organic growth in the Americas Industrial business could remain in the low to mid single-digit levels. EMEA Industrial sales grew at a low single-digit pace in the third quarter, similar to the year-to-date organic growth rate.

Worldwide Industrial demand levels remain decent, and we're seeing contributions from nearly all product categories. In addition, QED and EcoQuip, the two businesses we acquired in December of last year, both posted strong sales in the quarter.

Next, let's talk about Lubrication. Worldwide, [Lube] posted mid single-digit growth, aided by double-digit growth in the Americas and EMEA. Growth in the Americas was driven by double-digit increases in both our Vehicle Services and Industrial Lube product categories.

In Asia Pacific, Lube was down double-digits. Our Asia Pacific Lube business continues to have significant exposure to mining, and our orders from key mining customers have been lumpy. Moving on to some comments regarding EMEA and Asia Pacific.

Our lowest single-digit growth in EMEA came entirely from the developed economies in the West, which grew at nearly a mid single-digit pace, while the emerging markets were flat year-over-year. Russia and the Middle East were down double-digits in the quarter.

Economies of central Eastern Europe have performed very well this year, growing at a very strong double-digit pace and offsetting all of our declines in Russia. With mid single-digit growth in the West year-to-date, we've seen a shift in our sales split from the region, with 65% developed economies and 35% emerging markets.

The Asia Pacific region grew mid single-digits organically in the third quarter against their easiest comp of the year. Growth was strong in China, India and Australia. Japan was relatively flat and Southeast Asia was down. We continue to see variability in bookings and billings by country and product line.

Before commenting on our outlook for Q4 in 2015, I'll briefly mention a few developments that have occurred this month. On the first of October, we announced the acquisition of Alco Valves, a UK-based manufacturer of high pressure, high quality valves for oil and natural gas and industrial process applications.

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We have a slide in our earnings call deck on our website with additional information and product pictures. The purchase price was GBP72 million, and Alco had sales, for the most recent trailing months, of GBP19 million. We historically had a limited presence in the oil and natural gas market.

[Through] our internal growth strategy work, we identified some interesting niche opportunities for Graco in the space. In addition to targeted M and A efforts, we've also recently funded product engineering resources to address some specific market opportunities.

This is a long-term play in that market. In a market that, although cyclical, should be a good space for decades to come. On October 6th, the FTC issued its final decision [and order] with respect to the Liquid Finishing brands that we purchased from ITW back in April of 2012. There were no surprises in the final order.

And, shortly following, we announced an agreement to sell the business to Carlisle Companies for $590 million. After taxes, transaction costs and harvesting the remaining cash, we expect to receive $570 million in net proceeds. As always, we intend to redeploy the capital in a disciplined fashion, including strategic acquisitions where we can add value and share repurchases.

[Now a] few comments regarding our outlook for the fourth quarter. In the Americas, we're expecting Industrial growth in the double-digits with organic growth in the low to mid single-digits. We expect our Contractor business to post double-digit growth while the Lubrication business is expected to have mid single-digit growth.

All in, the Americas should grow in the mid to high single-digits organically for the fourth quarter, and in the double-digits when you include acquisitions. We expect our overall EMEA region to grow organically in the low single-digits in the fourth quarter against our toughest comp of the year.

And for Asia Pacific we expect the region to grow low single-digits in the fourth quarter also against a difficult Q4 comp from last year. Overall, we believe Graco can achieve mid single-digit organic sales growth in the fourth quarter and double-digit top line growth after the inclusion of acquisitions.

So far, the first nine months of the year have been closely aligned with our outlook and we like how the first few weeks of the fourth quarter have developed. We look forward to achieving a great [goal] of full year sales record as we finish 2014.

Some initial thoughts on 2015. It's early in the planning process and we have limited visibility in our business but for 2015, we, again, are planning to achieve organic growth in every reportable segment and in every region of the world.

Our plan relies on a continuous focus -- a continued focus on new products, new markets, expanded distribution and end user conversion. Most of the resources we need are already in place. We expect the US construction environment will continue to improve and that our Contractor Americas business will grow nicely again in 2015.

We'll wait to see how the macro environment develops as we exit the year before we provide 2015 outlook by division and region. It's probably safe to say that exchange rates are going to be a headwind in Q4 and into 2015. And I'd also note that we could see an increase in our pension expense in 2015 if interest rates stay low.

There isn't much more I can offer on 2015 at this point. As I said though, we'll be planning for organic growth in all reportable segments and all regions. Operator, we're ready for questions.

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QUESTIONS AND ANSWERS

Editor

Operator: Thank you. The question and answer session will begin at this time. (Operator Instructions). And that first question comes from Mike Halloran with Robert W. Baird.

Mike Halloran: Good morning, guys.

Pat McHale: Hi, Mike.

Mike Halloran: So first, just on the capital employment piece. After all the dust settles here, you're going to have $800 million plus of capital and you're also talking about making sure that you're patient in attacking the right opportunities. Great cash generation model.

As you guys continue to bring in the cash flow here, how do you balance not having too much of a cash-on-hand with the proper deployment? In other words, talk about the steps that you have out there between getting these acquisitions done but also buy backs and dividends and things like that?

Pat McHale: Well, we've communicated our dividend strategy and I expect that we'll maintain that in terms of [giving] that 25% to 30% of our cash flow back to shareholders on an annual basis. On the acquisition front, we invested a lot back in 2008 to try and put some dedicated resources on.

It's taken some time to build a pipeline. I feel actually better about our pipeline every quarter that goes by, in terms of having more opportunities identified. Pricing is high in the marketplace right now. And we're not just going to go and spend the cash to get it off the balance sheet.

We need to make sure that we can find something where we think that we can get a good return and add some value. So although I'm happy with the pipeline, it's hard to predict exactly what's going to happen on the M and A front.

So it could be that we'll have an opportunity to use a significant amount of cash on M and A or it may turn out that we can't. And certainly between how that plays out and what we see happening in the stock market, we'll be making our decisions on what the appropriate level of share buy back is.

We have communicated that our most current target is to get our fully diluted share count down below 60 million. Our basic count is now below 60 million but we're going to try to scrape off some more and get our diluted count below 60 million.

Other than that, we're not going to make any big promises at this point. We'll going to continue to work hard to try to bring some deals to the table over the course of the next six months.

Mike Halloran: And then on demand trends in general. What's the -- How did European, on a whole, track through the quarter? Obviously, you gave the low single-digit organic growth against a tough comp in Europe for your guidance for the fourth quarter.

But just curious about the sequential trends through the quarter, what you've seen so far to start the year and any kind of customer commentary and feedback so far.

Christian Rothe: Yes. So -- Hi, Mike, this is Christian. Generally, as we looked at third quarter and the way things [phased] through, we started off quarter quite nicely. September was a little bit slower, probably more based on what was happening in EMEA. Things came back overall for our worldwide growth rate in the first three weeks of October.

So, generally, we feel good with the outlook that Pat just gave and how we're tracking against it. Keeping in mind that the EMEA numbers are, again, probably going to be in the low single-digit range.

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Mike Halloran: Last one for me on the Contractor piece. Maybe any comments about mix in the quarter from the high end, more complex stuff you sell to contractors versus some of the more consumer, residential-driven stuff that you guys sell?

Pat McHale: Yes. So our mix in the quarter, as I mentioned, we had mid teens growth in the paint channel. And we're flat against a tough home center comp. But we kind of peel that apart and take a look at the mix within product segments. It looked, I'd say, pretty stable.

Maybe a slight tweak in the quarter favorable towards the larger units. But I'd say not any movement that I would consider significant. So I would say we didn't see, really, the trend moving stronger one way or the other.

Mike Halloran: Great. I appreciate the time, as always.

Pat McHale: Alright, thanks, Mike.

Operator: And our next question will come from Matt Summerville with KeyBanc.

Matt Summerville: I was just wondering if you can maybe give a little more end market granularity across the regions and how things played out in the automotive, non res construction and some of your other larger end markets, Pat and Christian.

Pat McHale: Sure, I can give you a view. Global automotive remains okay. Generally, we see the automotive factories are running and they're making investments. So I'd say that, that remains a positive end market for us pretty much globally at this point. Construction, of course, is the strongest here in North America.

And we're still seeing improvements in non res. There's -- people have been kind of waiting for non res to maybe catch a little bit more fire than what it has, and I'd say we'd welcome that. But certainly, non res, I wouldn't consider that to be negative or flat. That's improving. And we expect it, going into 2015, non res is going to continue to improve.

Construction in Europe, it's up slightly off of really low levels, but we're talking sort of on that 0% to 1% range for the markets that we're watching over there. So from a construction standpoint, Europe is, especially Western Europe, is pretty slow. And China, it's always hard to know what the numbers are, but we were over there in August.

And despite the fact that likely, the macro has slowed quite a bit, there's still plenty of opportunity for us over there. I saw trains all over the place when I was over there. So it may be flat or they may be down from where they were.

But from a Graco standpoint, with the opportunities that we have on penetration, we still think that we can execute much better and we have upside in that region. I'd say aerospace is -- remain a decent market for us. And on a kind of soft market side, our mining continues to be soft.

Matt Summerville: Got it. And then just with respect to the Contractor business and the paint -- conversion away from brush and roll to spray, where would you say we're at in EMEA between Western Europe, emerging markets and then in Asia Pacific relative to the U.S.?

Pat McHale: Yes, it's -- nobody out there can track that. So all we have is kind of our anecdotal evidence. But in the West, in Europe, talking about Germany and France, we're probably in that 40% to 50% kind of conversion rate. And if you talk about the East, you're going to be probably at 10%.

Most of Asia Pacific, with the exception of Australia, again, is probably in that 10%. I've been disappointed, frankly, with the growth rate that we've got out of some of the emerging markets. And we're trying to figure out what we can do differently to kind of get that going again here.

As you've seen, not just the last quarter, but recently, particularly in Asia Pacific, we've been challenged to get back to that kind of double-digit growth rate that should be possible out there if we're doing what we need to do on end-user conversion. So there's still a lot of opportunities, a lot of upside, and I'm sure we can get it. We've just got to maybe work a little harder.

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Matt Summerville: And then just lastly, if 10 years going to stick around current levels, how much would you expect pension expense to increase next year?

Caroline Chambers: So if we -- at the current interest rates, we've -- and we've noted this in the past in our [Form 10-K], the effect of a 0.5 point decrease in discount rate has a $2 million to $3 million effect on our pension expense.

Matt Summerville: Great. Thanks.

Operator: And next we'll take a question from Charles Brady from BMO Capital Markets.

Charles Brady: Okay, thanks. Good morning.

Pat McHale: Good morning.

Charles Brady: Just a couple questions. Back on Contractor, just so I understand the mixed paint channel, home center. The margin differential between those two is better in paint channel, correct?

Pat McHale: That is correct.

Charles Brady: So I'm just trying to square that up with the commentary on mix, given that paint's up teens, home center's flat but there's a margin headwind on mix. I'm missing a piece of that, if you could help me out.

Pat McHale: No. So the question that I was trying to answer was what did we see from the mix from kind of the large to the small. That's been an ongoing question that we've been asked here for three or four years. During the downturn, we saw people buying down the product line and buying smaller units.

So I was really only reflecting what the third quarter looked like. And paint, for sure, grew faster than home center. But when you peel it deeper and you look within paint, okay, just forget the fact that paint grew faster than home. And if you look within paint, I would say that the mix was -- there was a little bit of noise in there, but it was relatively stable.

I didn't see a big shift in mix towards smaller or back towards the larger units. It looked relatively consistent. That's all I was trying to address there. So if you have a different question you could ask that. But that was what my answer was trying to address.

Charles Brady: No, that clarifies it. So my next question is just on the Alco Valves acquisition. Can you just give us a sense of -- I mean, the manufacturing process, generally for valves, there's a lot more machining. It's a little more intensive than a lot of what you guys do currently for the products you make.

Pat McHale: Shame on you. Shame on you for saying that. No, if you take a look at the products, and then we have some pictures in there, they look just like the things we make. And when you take a look at what we're doing in our factories, we machine our pumps, we machine our gears, we machine all of our gear housings.

It really is not -- and we make valves. We make regulators. We make pressure control. So we buy out our plastic injection molded parts, we buy out forgings. But our factories are primarily machining and final assembly. And when you take a look at what Alco is doing, it's very similar to that.

Charles Brady: Alright. Fair enough. How about the distribution for that business, the sales process of how those get sold?

Pat McHale: Yes, it's definitely different. And I don't see that we're going to be -- get any synergies that are going to be significant on the distribution side nor did we expect any. Really, we're looking to build in a new place and where I think that we can add value.

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First of all, we can bring our capital to the table for some of these opportunities. We believe we understand the product fairly well. So from an engineering standpoint, we hope there's some value we can add there. And certainly, from a manufacturing standpoint, it lines up nicely with what we do.

We hope that we can invest more in the business and they can get more machines and they can look more like a Graco factory and we can take cost out doing that. So we're trying to build a position. We think it's a nice brand. They've got a lot that we don't have, and we're looking just to build off of that.

Charles Brady: Great. Thanks, Pat.

Operator: Our next question will come from Jim Giannakouros from Oppenheimer.

Jim Giannakouros: Good morning, guys.

Pat McHale: Good morning.

Jim Giannakouros: A quick follow-up there. I know that you've mentioned certain end markets, like oil and gas, sanitary, pharma, et cetera, as far as targeted areas for M and A. And the draw, just as you mentioned, Pat, being more on the manufacturing and engineering, as far as value creation once acquired. But are there opportunities to leverage your current distribution relationships that you are exploring?

Pat McHale: Absolutely. And whether we'll bring any of those home, I don't know. But we -- that's -- we do several different cuts. We look at technologies where we think we can add value. We look at end markets that we think are, I'll say, niche, where the customer is willing to pay for quality and for precision. We think we can add value there.

And we also look for opportunities where we can leverage our channels. So we've got people working in all those areas. Currently, right now, I think we're more likely to be able to add value on the manufacturing or engineering side than to leverage our channel, but that could change tomorrow.

Jim Giannakouros: Got it. Okay. And then a quick one on Lube. You've been growing mid singles there but your operating margin kicked up to 22% this quarter, which was a little surprising given last quarter, your comments around growth investments, et cetera.

Can you just talk about, I guess, either end market strength or what you're doing on the cost side? Explain a little bit of the lumpiness as far as profitability in Lube. And is that 22% sustainable?

Pat McHale: My expectation for Lube is if they're growing the top line, that they need to deliver in the low 20s on operating margin. And they had a couple of nice years of growth, and then last year it kind of hit a little bit of a rough patch. And they've done a nice job since then of making sure that they're managing expenses, but you can see they've got the top line growing again.

So I think there could be some noise around that number. I think that they'll continue to manage that in the low 20s, and I'm looking forward that they're going to continue to grow.

We had growth in the Americas in both our vehicle services and our industrial lube businesses at double-digit. Certainly, the end markets aren't growing that fast. But healthy investments from our automotive dealer customers have been a positive for us on the vehicle services side of the business.

And on the Industrial Lube, our share is tiny. And we keep working to add new accounts or to knock OEMs off and, to the extent that we can be successful, we can put up some decent growth numbers there as well.

Jim Giannakouros: Okay, great. Thank you. Thanks for taking my questions.

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Operator: Our next question will come from Global Hunter Securities' Walter Liptak.

Walter Liptak: Hi. Thanks for taking my questions. I wanted to ask about Europe. And I understand that, based on your comments, that you're expecting it to grow. But people are talking about Europe going into a recession. I wonder if you could talk about the product mix, especially in Western Europe, and if something were to slow, what -- how should we look at that for next year?

Pat McHale: Yes. I mean, a recession is bad for us. If an area goes into recession, typically, people start to look pretty closely at things like capital spending. And a lot of what we're selling, particularly on the industrial side of the equation, is a CapEx spend for our end customers. So a recession would be bad.

At this point, we're forecasting a low growth environment, not a recession. But I'm not an economist, and I probably read the same sort of things that you do. So we're -- our plans are based upon a low growth environment for Western Europe, not a retraction.

Walter Liptak: Okay. Are there certain product groups that we should be more aware of than others that are early to slow?

Pat McHale: No. Our sales, really, in Western Europe are -- across the Graco product categories, not -- doesn't look significantly different than what you'd see in North America. We have different drivers for different segments of our business. Certainly, our Contractor business is much more tied into what's happening in the construction markets, where our Industrial business is more related to what's happening with the GDP growth or industrial production.

So if you remember back in, I think it was the 2001 time frame, when Industrial had some challenges, Contractor was hot and it blew right through there and kind of carried us through. So that can happen. But, generally, a recession is bad for all of our businesses.

Walter Liptak: Okay. Got it. Let me try one on pricing. And I wonder if you can give us an update on when you had price increases in North America go through. And any benefits from commodities at this point?

Pat McHale: No. I'll talk about pricing and then I'll let Caroline and Christian pick in as they see fit on the commodity side. But we typically put our pricing through at the beginning of the year. And we did that in 2014, and we'll do that again at 2015.

Typically, we realize somewhere between 1.5 and 2 points on price, and we would expect in 2015 for that to continue. On the commodity side, Caroline?

Caroline Chambers: Yes, we had a little bit of pressure on materials early in the year, and it's remained consistent throughout the three quarters so far. And, at this point, not seeing a big change for the fourth quarter as well. We watch the commodity markets and maybe something next year but we're not planning a dramatic change at this point for the fourth quarter.

Pat McHale: It's hard to envision how we would have low growth and a lot of commodity pressure. I would think if we have commodity pressure, that's going to be because the economies are improving, which is going to be good for us.

So we don't lose a ton of sleep over what's happening with commodities here. Plus, our high gross margins, I think, insulate us from commodity moves a little bit more than it may folks that have lower gross margins.

Walter Liptak: Got it. Thank you.

Operator: (Operator Instructions). And our next question will come from Liam Burke with Wunderlich Securities.

Liam Burke: Pat, you put out a bunch of new product releases into the contractor markets just as we're seeing the uptick in commercial construction. Is there any product line or vertical that you're looking at to put out some new product releases?

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Pat McHale: Yes, we've got -- our engineering resources are not centralized. They're decentralized. So each one of the divisions has its own product development, and they have their own five year product plan. And every year in every division, we're launching product.

And I'd say, from about 2007 or 2008, up through maybe 2012 or 2013, we were ramping up our investment expense there pretty significantly. And that really resulted in more new products coming off for Graco in recent years than we have had in the past.

We sort of leveled that expense increase off a little bit now. It's not the dramatic ramp up that we had. And I feel pretty good about the new product plans that we've got for the next two, three years. You should continue to see new products coming out in each one of our segments, and I would say probably at about the magnitude that you saw in 2013, 2014.

Liam Burke: Okay, great. You talked about sanitary and pharma being an area of potential acquisition. How are those businesses doing right now just organically or growing deep without acquisitions?

Pat McHale: Yes, it's a small number for us. But that -- those businesses, over the course of the last two or three years, have been growing a little bit faster than, I'd say, our industrial average. So we think it's a good space. The fact that we're small, I can't really say that growth is being driven by anything that's happening in the market.

It's probably more related to us picking up a new distributor here or there or launching a new product into the space. Really for it to be significant for Graco, we need to have a broader product line and we need to have some brand exposure. And really, I'd like to see us be able to get some M and A done in that space.

I think that could help move us forward. In the absence of being able to find something, we're continuing to hammer away at launching incremental products in the space, but it's really a long road to get there that way. So I think a two pronged approach like we're trying with oil and gas would be a more effective approach, and we're working hard on that.

Liam Burke: Great. Thank you, Pat.

Operator: Our next question will come from Jim Krapfel with Morningstar.

Jim Krapfel: Good morning. Thanks for taking my questions.

Pat McHale: Good morning.

Jim Krapfel: Just taking a step back for a moment and looking at your four major strategic growth initiatives that you've highlighted in the past. Curious to hear your thoughts on which of those do you think is -- provides the greatest opportunity to drive future growth?

And then also, which has proven to be the most challenging to date? And I'm guessing the end user conversion to be the most challenging to date, based on your prior comments.

Pat McHale: Yes. And probably also the most long-term opportunity. If you take a look at -- our Contractor business is a big business for Graco. And when you take a look at the equipment usage rates around the world, they're really high in a few of the developed markets and they're really low elsewhere.

So the pie is going to get a lot bigger over the next 20, 30 years, and that's really a great opportunity for Graco. It also has been, frankly, a challenge for us, particularly, I'd say, the last, I don't know, six or seven quarters, I'd have to go back and look. But -- so we're working hard on that.

We've got a significant step up in our initiative for end user conversion down in South America, getting some traction there. China, in particular, has been a little bit disappointing, although other areas of Asia Pacific, we've been doing, I'd say, a decent job.

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Russia and the East had been a nice story for us. It's a little bit noisy over there right now so I'm not so sure exactly how that's going to play out over the next couple quarters. But over the long term, I think that's going to be the big opportunity. So I like all of our growth initiatives.

Obviously, we stick to them and we keep them moving forward. But that end user conversion opportunity and to have the pie just get significantly bigger than it is today, I think it's the biggest upside and probably also the biggest challenge.

Jim Krapfel: Thanks for the color.

Operator: And we'll take our next question from Mario Gabelli from GAMCO Investors, Incorporated.

Mario Gabelli: The Alco Valves, a couple of nits.

Pat McHale: Good morning.

Mario Gabelli: Good morning.

Pat McHale: Good morning, darling. (Inaudible)

Mario Gabelli: Hey, I know. I agree. But that cost me a beer.

Pat McHale: Okay, I'll send you one.

Mario Gabelli: The Alco Valves, a couple of nits. The addressable market for Alco Valves, do you break it down between the gate, needle, ball, block and [bleed]? How do you break that down? Do you -- ?

Pat McHale: Yes. So if you take a look at what -- they're about 70% oil and natural gas and 30% industrial process. So they fit nicely with both of our initiatives. That 70% in the oil and gas side, that's about -- of that 70%, that's about two-thirds is offshore and one-third is onshore.

And of the offshore part, part of that is sub sea. So we like offshore. We like sub sea. And, hopefully, we'll be able to see continued growth in those categories. In terms of by product line, I mean, those -- when you start taking 70% of a small number and breaking it --

Mario Gabelli: Yes, I've got it. Small number. I've got it. Alright. No problem. I've got page 20 in front of me. Pat, did you -- who is the competitor in the product lines that you're selling these markets? Anybody in particular?

Pat McHale: There's a lot of people. I think that provides a lot of opportunity for us as well, both on the M and A front. There's hundreds of millions of dollars of equipment that we like that sold into the oil and gas space. And we don't like everything that's in that space. We're not out there just saying, well, if it's oil and gas, we want it.

We're really looking for niche stuff where we like the high pressure. We like the stuff that's got a lot of machine content. We like things at precision. We like metering. So we, really, within that whole big world of oil and gas pressure and flow control, we've really tried to pick the niches where we think that it's Graco-like.

Mario Gabelli: I'll give Christian some of my holdings then we can talk about them. Are you buying assets or you're buying C Corp?

Christian Rothe: In the Alco transaction, we are -- that was a share acquisition.

Mario Gabelli: And what's the balance sheet of the target of Alco? Was it anything unusual or is it just pure working capital with no debt, no cash?

Christian Rothe: Yes, pretty clean. A relatively small amount of capital. Not a lot of assets overall.

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Mario Gabelli: Got you. And the GBP72 million you paid, you financed that with a cash from the offshore holdings?

Christian Rothe: Actually, we drew it off of the revolving line of credit and did it through our European structure, yes.

Mario Gabelli: Yes. Alright. Thanks very much. And happy hunting.

Pat McHale: Okay, thank you.

Mario Gabelli: Thanks, [Bubba].

Operator: (Operator Instructions). And there are no further questions at this time. I'll now turn the conference back over to Pat McHale for any additional or closing remarks.

Pat McHale: Alright. Well, thank you, everybody, for attending. We've got our work cut out for us but you can be assured that we're going to continue to work hard. And we'll talk to you all again late January. Thank you.

Operator: This concludes our conference for today. Thank you all for participating. Have a nice day. All parties may now disconnect.

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