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GGG - Q2 2014 Graco Earnings Conference Call

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OVERVIEW:

Co. reported 2Q14 sales of \$323m and net income of \$66m or \$1.07 per diluted share.



CORPORATE PARTICIPANTS

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Evelyn Chow *Goldman Sachs - Analyst*

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Liam Burke *Janney Capital - Analyst*

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PRESENTATION

Operator

Good morning, and welcome to the second 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 number is 1832522. The replay will be available through July 28, 2014.

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 up the conference 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 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, this presentation is being recorded.

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

Caroline Chambers - *Graco - Principal Accounting Officer*

Good morning, everyone. I'm here this morning with Pat McHale and Christian Rothe, Jim Graner is on vacation with his family. 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. Sales were \$323 million, an increase of 13% from the prior year. Sales from the recently acquired



EcoQuip and QED businesses were \$10 million, or four percentage points of our overall growth. Regionally, sales in Americas grew by 15%. Sales in EMEA increased by 12%, or 8% at consistent translation rates, and sales in Asia Pacific increased by 7%, or 6% at consistent translation rates.

Gross profit margin, as a percent of sales, were 55% for the quarter, as compared to 55.5% in the prior year. The slight decrease in gross margin rate in the quarter is primarily due to product mix, mostly from the effect of entry-level products in the Contractor segment. Operating expenses, as a percent of sales, improved slightly as compared to the prior year, and included \$2 million of incremental expense related to the acquired businesses, and \$2 million for incremental investment in South and Central America and for products and market development initiatives.

Acquisition transaction costs were about \$0.5 million in the second quarter and \$1.5 million for the first half, consistent with last year. Other income includes dividends of \$11 million from the Liquid Finishing businesses, consistent with the second quarter of 2013. The Liquid Finishing businesses are accounted for as a cost investment, since we cannot control the operations of Liquid Finishing under the terms of the Hold Separate Order from the Federal Trade Commission. When the Liquid Finishing businesses are sold, 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 in second quarter Form -- 2014 Form 10-Q.

The effective tax rate for the quarter was 28%, one percentage point lower than the prior year. Net income totaled \$66 million, or \$1.07 per diluted share. Cash provided by operating activities was \$56 million in the second quarter. The use of working capital was in line with volume and seasonal trends, and days of sales outstanding for accounts receivable remained consistent. In the quarter, capital expenditures were \$10 million. Dividends paid totaled \$17 million, and share repurchases net of shares issued totaled \$44 million.

A few other discussion points. We have taken occupancy of our new warehouse, and will begin moving in. The effect on operating expense is expected to be approximately \$2 million for the remainder of the year.

We expect the dividends from Liquid Finishing to be \$9 million in the third quarter, the same as the third quarter in 2013. The tax rate for the third quarter and the full year is expected to be approximately 29% to 30%, excluding any effects from an eventual sale of the Liquid Finishing investment. This estimate also assumes that the federal R&D tax credit is not reinstated for 2014.

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

Pat McHale - Graco - President, CEO

Thanks, Caroline. Good morning, everyone. Our business in Q2 was solid. And with the first of the year behind us, we are well positioned to meet or exceed our 2014 outlook. Growth has been decent in the developed economies worldwide, while growth in the emerging economies remains choppy, but is on a positive trend.

In the quarter, sales grew at a low double-digit pace, with high single-digit growth organically. We experienced growth in all segments and regions. As expected, our Contractor business posted double-digit growth in the Americas in the second quarter. Both the paint store and home center channels grew at a double-digit pace. The segment also achieved double-digit growth worldwide against the tough comparisons in the prior year, where the segment grew 20%. The quarterly performance was aided by double-digit growth in EMEA, while Asia/Pacific was relatively flat. I do expect contractor sales in both EMEA and Asia/Pacific to grow in the single-digit in the second half.

Contractors had a nice string of wins on the entry-level side of the business in recent years, and strong growth in this category continued in the second quarter. These units sell at a lower list price and have lower gross margins, but they help establish Graco as the brand of choice for part-time and entry-level painters, drive innovation in our engineering and manufacturing groups, and provide volume benefits in our factories. Although growth of this product segment dampens the overall margin percentages in Contractor, the overall growth in profit dollars has been good. In fact, Contractor worldwide sales are at record highs and operating earnings in the second quarter were only \$1 million below peak quarter, a peak that occurred back when US housing starts were more than 2 million and the Southern European construction market was on fire.

Moving on to Industrial. Our Industrial segment posted low-double-digit growth in the second quarter worldwide. On an organic basis, the business achieved mid-single-digit growth in every region. We continue to see broad-based demand. Automotive, ag, construction and aerospace markets

are healthy, while mining remains soft. After a somewhat slower start in Q1, our recently acquired businesses, QED and EcoQuip, both had a strong quarter. The integration of these businesses is going smoothly, and we are gaining synergies on the top and bottom line. Flow-through profitability in Industrial, excluding the impact of recent acquisitions and our incremental regional and product growth investments, performed above our corporate target, and looks well-positioned for the remainder of the year.

Moving to Lubrication segment. Worldwide, Lube posted nice growth and solid 23% operating margins. Sales grew double digits in the Americas and mid-single digits in Asia/Pacific. The EMEA Lubrication was down double digits year-over-year off a small base. Growth in the Americas was driven by increased sales of our Industrial Lubrication products, reflecting higher demand in on-road and off-road applications, as well as products used for lubricating CNG compressors. In Asia/Pacific, the Industrial Lubrication business, which is heavily weighted towards mining, was flat, with growth in the second quarter coming from our legacy vehicle service products.

A few quick comments on the regional results. Our growth in EMEA was relatively broad-based throughout the region, the developed economies in the West growing at a high single-digit pace, and the emerging markets growing in the mid-single digits. Our sales split in the region is currently 61% developed economies and 39% emerging markets. Russia remains difficult with double-digit declines, but we continue to see growth in other emerging markets in EMEA. In Asia/Pacific, we saw good growth in shipments in the second quarter throughout the region with the exceptions of Korea, where we had some large automotive activity in the prior year, and India. On the demand side, we've experienced a decrease in bookings in certain Southeast Asian economies, reflecting the unrest in Vietnam, Indonesia, and Thailand. Other emerging economies in Asia/Pacific have made up for Southeast Asia's shortfall.

Now for a few comments in operating margins and on our investment strategies for long-term growth. We continue to invest for Graco's long-term, viable organic, and acquisition initiatives. As you know, we completed two acquisitions in the month of December. While small, these business have added \$17 million of sales to the Company in the first half of the year, and \$2 million in operating earnings, which included the adverse effect of \$1 million in purchase accounting.

We continue to ramp investments in regional and product expansion. In recent quarters, we spent some time discussing the incremental investments we are making, including sales headcount and commercial leadership structure in South and Central America, where we have historically had minimum [audio break] ground presence, investments in commercial and engineering personnel to gain a foothold with our new InvisiPac product line in the hot melt adhesive market, and expansion of commercial and engineering personnel in our processed division, targeting growth in the oil and gas, sanitary, food and beverage, pharmaceutical, and cosmetics markets. I expect that these investments will be cash flow negative for the full year 2014, and in some cases, into 2015. For the first half of this year, these investments totaled \$3 million. I'm excited about the potential on these product categories and markets. We will continue to fund long-term growth initiatives, as long as good opportunities are identified. Organic growth investments typically provide a strong ROI for Graco shareholders.

Of course, these organic and inorganic investments do hamper our flow-through profit margins on incremental sales growth in the short term. For the second quarter, our incremental profit margin was 29%. We typically look to have between 35% and 45% incremental profit margins on organic sales growth, and have a long history of achievement in this metric. For an apples-to-apples comparison, however, we need to peel away the sales and earnings effect of recent acquisitions and our investments in regional and product expansion. If we do that, our incremental profit on a purely organic basis for the second quarter is 40%, while the year-to-date and trailing 12-month incremental profit measured on the same basis only varies by a couple hundred basis points. In other words, we're squarely in our target range.

Moving on to the Hold Separate Finishing brand situation. We continue to dialogue with the FTC, but remain uncertain as to the timing of a final decision in order. For the meantime, the business is performing well, and continues to generate cash.

Before turning it over for questions, I'll go through our outlook for the balance of the year. In the Americas, we're expecting Industrial organic growth in the mid-single digits for the remaining half of the year, and should post a number in the double digits with the acquisitions included. Contractor Americas should have a second-half growth rate in the low double digits, and the Lubrication Americas business is expected to post growth in the mid-single digit. We're continuing to expect our overall EMEA region to grow organically in the low to mid-single digits. And in Asia/Pacific, we do expect low to mid-single-digit growth in the second half. Overall, we believe that Graco can achieve consolidated growth in

each of the remaining two quarters, and we see upside to our outlook for mid-single-digit organic sales growth for the second half of the year. The acquisitions of QED and EcoQuip should add another three points of growth on top of that.

We're pleased with our performance in the first half of the year, and we'll continue to execute our investment strategies to drive long-term shareholder value. We look forward to a good second half, and another record year in 2014. Operator, we're ready for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). And we'll hear first from Joe Ritchie of Goldman Sachs. Please go ahead, sir.

Evelyn Chow - Goldman Sachs - Analyst

Good morning. This is Evelyn Chow for Joe. Solid quarter in Contractor, really tested [indiscernible] your performance there. However, last quarter, Pat, you mentioned being disappointed in the 26% incrementals. And while you saw an uptick in this quarter, it still fell a bit short of your normalized 35% to 45% range. So if you could explain a little bit further on what happened there and what your expectation is going forward, that would be great.

Pat McHale - Graco - President, CEO

Yes, that's really the mix issue that we talked about in terms of the faster growth in that entry-level product versus the good growth that we're seeing in the larger units. It's just a -- I think it's not a concern of mine at this point. I'm happy with the growth in the low end. They've done a nice job on channel, and it's just the way the numbers tumble out.

Evelyn Chow - Goldman Sachs - Analyst

Got it. And a quick follow-up, turning into Industrial, in your press release, you cited that demand levels around the world firmed in 2Q, and you clearly saw some pretty solid growth, especially in Industrial. Can you give us some color on what you're seeing specifically at your customers and what they're saying in terms of capital spending?

Pat McHale - Graco - President, CEO

Yes, it's generally, as I mentioned, in most of the regions, the demand that we've seen has been pretty broad-based. It hasn't been focused on any particular end market or product line. We've got a fairly broad product offering, and we saw a nice growth really across that offering. And from an end market perspective, other than calling out that mining still remains pretty soft, we saw our customers and most other segments investing in capital and running their factories at a pretty good utilization level.

Evelyn Chow - Goldman Sachs - Analyst

Got it. And if I can just make another quick one in here, this quarter, APAC comps eased a bit, but clearly, the improvements don't imply the healthy step-up in the underlying. First off, looking at the back half, as comps toughen by 700 bps, and in line with your commentary in moderating bookings in Southeast Asia, can you just give a little bit more color as to what gives you confidence in being able to reach that positive growth for the full year?



Christian Rothe - Graco - VP, Treasurer

Yes. Evelyn, this is Christian. Generally, if we look at those comps, I'd have to go back and confirm your 700 bp number. But as we're looking at our run rate currently and the incoming order rate, we feel okay that we're going to continue to have a nice trajectory there, and that the comps overall don't provide a huge concern for us. Q4, obviously, is going to be a little bit more difficult than Q3.

Evelyn Chow - Goldman Sachs - Analyst

Great. I appreciate you taking my questions. Thanks.

Operator

And Matt Summerville of KeyBanc has our next question.

Matt Summerville - KeyBanc - Analyst

Morning. A couple of questions. First, just in terms of in Contractor, the mix between, if you want to call it, high end versus low end, where are -- do you sit today relative to the last cycle peak and trough? I'm trying to understand how your mix could evolve going forward.

Pat McHale - Graco - President, CEO

Yes, you can't really compare back to 2006. Our product line looks different. And of course, our channel situation on the entry-level side has significantly expanded since 2006, with the addition of major home centers around the world. So if you look at our mix today versus our mix at the prior peak, we definitely have more mix towards the low end.

Matt Summerville - KeyBanc - Analyst

And then, as you think about just strategically kind of capital deployment, if and when you're finally able to sell the Liquid Finishing businesses, Pat, how quickly do you think you can backfill the roughly \$0.45 a share annually you're getting in dividends from that business, and how would you anticipate doing that?

Pat McHale - Graco - President, CEO

Well, obviously, we spend a lot of time talking about how we're going to do that, and I can't tell you at this point how quickly we'll do that. We have a few tools at our disposal. Obviously, if we could find a deal that gave us good synergy opportunities and would give us a nice shareholder return, that will be great, and that would be a priority. I believe we're already investing today in most of your organic growth initiatives that we've identified as being positive. So we don't really have, I think, a significant opportunity to put that money back to work through organic investments. And then of course, we have the option to do share repurchases. I'd like to think that we've got the discipline and patience to make the right decision when the time comes and not feel undue pressure to do something with the cash. Certainly, what we'd like to do is we like to maximize what we do with that cash in terms of long-term shareholder return.

Matt Summerville - KeyBanc - Analyst

Thanks, Pat.

Operator

And John Franzreb of Sidoti has our next question. Please go ahead, sir.

John Franzreb - Sidoti - Analyst

Good morning, Pat. I want you to discuss a little bit about some of the upside potential that you see from China and other emerging markets. What is the most visible near-term catalyst that you think that can emerge over there?

Pat McHale - Graco - President, CEO

Just taking a look at where we were, I'd say, over the course of the last six quarters or so, if we want to particularly talk about China, our business seems to be on the right track here the last, I'm going to say, quarter or two. We had some sort of flat periods at times in some of our business segments in China back in 2012 and 2013. So we're seeing some improvement there, maybe bottoming in some end markets, maybe some execution on our part. But I do feel better about what we're seeing in China as of late, and of course, that's a major driver of our business in Asia/Pacific, so we see that as a positive.

There are some headwinds in certain areas in Europe, particularly Russia. Turkey's been a little bit soft. But some of the other countries in the East and some of the other emerging markets that are covered by our EMEA region, again, demand seems to be solid across variety of product categories. It's not just one thing driving it. And usually, that gives us confidence that we've got some traction out there.

John Franzreb - Sidoti - Analyst

Okay. I might have missed this, but on the Lube side, it looks like you have higher revenue year-over-year, but the up margin was flat. Was there any particular reason for that?

Pat McHale - Graco - President, CEO

I'm satisfied with Lube operating margins in the low 20s as long as they're getting growth, and that's really been our strategy. We're trying to invest in growing that business. And if they hold operating margins in the low-20s and they're getting growth in the top line, then we're doing what we are trying to do.

John Franzreb - Sidoti - Analyst

Okay. And one last question. Why change the dividend on the Liquid Finishing side from \$0.11 to \$0.09? Is there a seasonality in that business or any rationale there?

Christian Rothe - Graco - VP, Treasurer

Yes, So John, this is Christian. Last year, we had a cadence of \$4 million, \$11 million, \$9 million and then \$4 million again. And so, as we made our plans for this year, we look to match that exact cadence from last year. So it's really about matching up with what we did last year as opposed to the actual cash inflows that are happening in the hold separate business.

John Franzreb - Sidoti - Analyst

Thank you guys for taking my questions.



Operator

And next, we'll hear from Mike Halloran of Robert W. Baird.

Mike Halloran - *RW Baird - Analyst*

Good morning, everyone. Could you just talk about the market acceptance you're seeing now in some of these new product introductions -- less so on the Contractor side, more on the Industrial side with some of the hot melt applications? How the flow-through have been and what the customer commentary has been?

Pat McHale - *Graco - President, CEO*

Yes, I'm very happy with the reception we've had on our recent Industrial product launches. Specifically, you mentioned the hot melt initiative, and that product was launched more than a year ago. But that's really channel building and testing, and end-user trial game for us now, and that seems to be going fine. We're getting nice growth in that product category. Obviously, a long ways to go and tough competition to fight that space. Our other Industrial products, they -- typically, no one Industrial product moves the needle. We launch a number of products out of our different Industrial divisions over the course of every year, and it's more like drops of rain. And we got to make sure that we've got a number of them going at any given point in time, and that they can give us an incremental two or three points of growth over what we get without them. And I think we're seeing that, no real disappointments on the product side. Quality has been good. Performance has been fine, and the products that we'll be released over the next of the course of the next six or nine months should be about consistent in terms of our volumes than what we've been doing here for the last 12 months.

Mike Halloran - *RW Baird - Analyst*

And then remind me again where that \$2 million expense related to the new lease facility flow-through?

Caroline Chambers - *Graco - Principal Accounting Officer*

So that's mostly going to flow through our corporate expense in the second half of the year until it starts to get used fully by a division. At that point, we'll run it through the divisional and segment operating earnings, and that will really just, at that point, compensate for the spaces that are already using that. We're using it subsequently for manufacturing expansion.

Mike Halloran - *RW Baird - Analyst*

Makes sense. And then last one, the commentary about kind of firming underlying trends. I'm assuming then that you saw improved underlying trend as you work through the quarter, which kind of gives you the comfort to the outlook. So maybe just a little bit of commentary around what that trajectory on the Industrial side looked like through the quarter and into July here?

Pat McHale - *Graco - President, CEO*

We don't have much of July under our belt here, but July seems to be solid like we've seen here through the second quarter. We expect normal seasonality. Europe gets soft in August, but it does every year, and we would anticipate that to happen again. Contractor typically has its second-best quarter of the year in the third quarter, and we think that that's likely as well again. So everything that we're seeing is sort of steady as she goes, and we would expect the cadence that we've got to continue.

Mike Halloran - *RW Baird - Analyst*

Sounds good. I appreciate the time, as always.

Operator

And next, we'll go to Charlie Brady of BMO Capital Markets. Please go ahead.

Patrick Woo - *BMO Capital Markets - Analyst*

This is Patrick Woo, actually standing in for Charlie. For -- just going to Contractor in EMEA, it was up quite a bit as compared to flattish last quarter. What was the organic growth rate here for the quarter?

Christian Rothe - *Graco - VP, Treasurer*

Yes, this is Christian. The organic growth rate in EMEA in Contractor was 14% in Q2.

Patrick Woo - *BMO Capital Markets - Analyst*

Okay. Great. And I think you guys mentioned that for EMEA, as a whole, the next -- the second half of the year will be growing in single digits. Now this is for the breakdown by -- which segments do you see strength in, I guess?

Pat McHale - *Graco - President, CEO*

Yes, I don't want to start breaking our forecast down quite that fine. I mean, we've got lots of product lines and lots of divisions. And if I start doing it by division, by regional, all of a sudden, it just gets to be a dartboard game. We generally feel that we're going to get growth across our segments, but we're a book-and-bill business. We don't have -- or book and ship, I guess, is probably a better term. And so we don't have a lot of visibility. So we're really looking at kind of underlying market conditions more than we are in kind of a shipping out of a backlog. So we feel good that we're going to get growth, but I don't want to try to predict it with that kind of precision.

Patrick Woo - *BMO Capital Markets - Analyst*

That's fair. I guess, moving on to Lubrication real quick, can you guys provide us some color into the bookings [indiscernible]? Can you provide any commentary that -- for the other two regions, the Americas [indiscernible] just so we can round out our thoughts on that?

Pat McHale - *Graco - President, CEO*

You're breaking up there. I didn't get the second half of your question.

Patrick Woo - *BMO Capital Markets - Analyst*

I was hoping that you can possibly provide some commentary into the bookings in the Americas and EMEA so we can just round out our thoughts on sort of the booking aspects on Lubrication.



Pat McHale - Graco - President, CEO

Bookings, so the backlog in Lubrication is pretty consistent with where it was at the end of the first quarter.

Patrick Woo - BMO Capital Markets - Analyst

Okay. And just one final one in terms of the acquisition landscape. How are you prioritizing the capital in the second half? I guess, more specifically, which areas are you more focused in at this current time?

Pat McHale - Graco - President, CEO

In terms of our capital deployment for second half, is that what you're asking?

Patrick Woo - BMO Capital Markets - Analyst

Exactly, yes.

Pat McHale - Graco - President, CEO

Yes, so we've got same tools at our disposal that we've had. We're continuing on a share repurchase with a stated goal of trying to get our shares outstanding down into that \$60 million -- or 60 million share count, and we're making nice progress against that. We've got the dividends. We've got our normal CapEx spending, which this year, should be in line with what we've seen sort of as an average over the last few years. We continue to look for M&A opportunities, although, I'll tell you, we're seeing people pay some pretty high prices. So from a capital allocation standpoint, we'd like to do some M&A, but we're not going to pay ridiculous prices to get it done. And then we're funding organic growth initiatives to the extent that we think that we've got good ideas. And we have ramped up, as I mentioned, engineering personnel and commercial personnel both in some of the regions, in some of the product lines trying to go after some organic growth. And other than that, the big event is going to be when we sell the Finishing brands, and we've got an infusion of dollars there that we're going to have to put to work.

Patrick Woo - BMO Capital Markets - Analyst

I guess, more specifically on the acquisition, on the M&A side, which you've mentioned, any particular segment that you guys are honing in on in terms of where you want to sort of shore up a little bit more than the others? Is that part of the priority here?

Pat McHale - Graco - President, CEO

So our priority is to stay in fluid handling. We're not really looking outside of fluid handlings, but there are a lot of adjacent markets that we've identified that we think are interesting. And certainly, things that will fall into what we call the process space are a priority for us. We broke the -- from an operation standpoint and leadership standpoint, we broke our process division out back in January 2013 so we can get more focus on it. And there, we're really looking at investments in oil and gas, in sanitary pumping, in pharmaceuticals, cosmetics. We think there's nice opportunity for Graco. We think that the core competencies that we have in manufacturing and engineering fit well there, and so it's not guaranteed that that's where our next deal will be, but I can tell you that we're spending a lot of time looking in those particular spaces.

Patrick Woo - BMO Capital Markets - Analyst

Thank you for taking my questions.

Operator

And Liam Burke of Janney Capital has our next question. Please go ahead.

Liam Burke - *Janney Capital - Analyst*

Thank you. Good morning Pat, good morning Jim.

Pat McHale - *Graco - President, CEO*

Good morning.

Liam Burke - *Janney Capital - Analyst*

Pat, on the powder coatings front, you've had it through the ITW acquisition. How has that been integrated and how's it been performing?

Pat McHale - *Graco - President, CEO*

Yes, we're very happy with how that's been performing. In terms of integration, I'll say it's been loosely integrated. That business is headquartered out of Switzerland, and that remains, and that's our intention, to have that remain. We've looked for commercial synergies by having our sales people in all the different regions to get together and take a look at where we have gaps in distribution, where either we could use their distribution or they could use ours. We've got some work going on in the product development front. We do some product categories where we believe that we can get synergies between the designs and powder and in our other Industrial businesses, and we have some active projects going there.

And then we've, of course, done some level of work on the manufacturing and purchasing front, although our manufacturing is heavily driven by machining of precision components and their manufacturing is driven -- or excuse me, their cost of goods sold tends to be driven more by assembly of product that is purchased from the outside. So a little bit different operational models. So the synergies between, from a manufacturing standpoint aren't huge, but we're still going after the ones that exist. So overall, we're looking across the spectrum, and we're making progress. So we're very happy with revenue growth, and we're making some progress on the margin side as well.

Liam Burke - *Janney Capital - Analyst*

If I just -- to just go over one point, you were talking about outside purchased components, and when you see acquisitions coming in, do you see opportunity to bring some of those outside purchase components and manufacturing them in-house?

Pat McHale - *Graco - President, CEO*

If they're precision machine parts, then there's a high likelihood that we'll bring them in-house. If it is other things, for example, the powder business, well, they sell a lot of boots, but we're not going to bring boots manufacturing in-house for the most part. We have a small exception there. But generally speaking, that's not the kind of thing that is a core competency for Graco. So we'll really look at machining, castings, and forgings, things that are made out of stainless steel. And to the extent that any acquisition opportunity has those kinds of parts on the outside, that's a significant part of our value model.



Liam Burke - *Janney Capital - Analyst*

Great. Thank you.

Operator

And now we'll go to Walter Liptak of Global Hunter.

Walter Liptak - *Global Hunter - Analyst*

Hi, thanks. Good morning.

Pat McHale - *Graco - President, CEO*

Good morning.

Walter Liptak - *Global Hunter - Analyst*

I want to ask about -- the revenue this quarter was better than my number and the consensus, and I wonder if there was anything that surprised you positively this quarter. And if it was -- if there was anything, is it from internal efforts, like the new products, or was it market-related?

Pat McHale - *Graco - President, CEO*

I don't think there's anything overly surprising. I think that the nice part about the quarter was is that we had good performance across really all of our product categories and most of our regions. So it was, I would say, not any one thing that made our numbers a little bit better than maybe we thought, but it was just the fact that we had performance sort of across the board, and that was nice to see.

Walter Liptak - *Global Hunter - Analyst*

Okay, got it. Thanks. Thanks for mentioning on the incrementals, the deals and the product expenses, but I wonder, what's your view on the second half? And what deal expenses and product expenses look like? And I guess what I'm trying to get to is are you expecting better leverage in the second half?

Pat McHale - *Graco - President, CEO*

Yes, not necessarily. It's going to probably depend on a few things, but the \$3 million that we spent on the -- in the first half on, what I'll call our incremental growth investments, I think we'll be about in that line in the second half. And on the first half, we also had the impact of mix on operating margins as well, and mix is hard to predict since we are interested every week in what got ordered last week. So I'm not predicting a lot of extra strength there, but I'll let Christian weigh in with his thoughts.

Christian Rothe - *Graco - VP, Treasurer*

Yes, I think that, generally, for us, we're more focused on that organic growth and the incremental profit margins that we get on that organic growth. And as Pat said in his prepared comments, the 35% to 45% is what we're looking for. And I think we're expecting that, generally, when we look at overall Graco for the second half, that's going to happen, with the exception of the items that he called out and those things, such as the



acquisitions, the growth in regional product investments. And then, of course, as Caroline mentioned in her earlier comments, we are going to have a little bit of additional expense related to the distribution center that recently opened.

Walter Liptak - *Global Hunter - Analyst*

Okay, got it. Thank you.

Operator

And now we'll hear from Nick Prendergast of BB&T Capital.

Nick Prendergast - *BBT Capital - Analyst*

Hi. Good morning. Just real quick on your Industrial segment, growth there is pretty good even when we back out the acquisitions. Could you -- first of all, I guess, was there anything special in there, some sort of channel sale, a new product or was that just -- perhaps, if you can just give some color around your Industrial growth?

Pat McHale - *Graco - President, CEO*

Yes, again, and I know it sounds like a boring story, but it really was broad-based. We had good growth across product lines. We had some new product, but I don't think anything significantly different than what we'd see in any other given year from an Industrial standpoint. We didn't have any big channel sale activities or anything unusual. It was just good demand levels around the world, good execution by the Graco team, reasonable acceptance of the products that we are launching, and it all added up to be a nice quarter.

Nick Prendergast - *BBT Capital - Analyst*

Yes. And then I think some of you actually touched on this earlier. But I didn't fully, I guess, get your answer. Just on the Contractor, obviously, that's been going gangbusters for pretty much over a year now, and we're coming up on difficult comps here in Q3. I guess, what are your thoughts on that and how do you see that playing out?

Christian Rothe - *Graco - VP, Treasurer*

Yes, this is Christian. Q2 was a difficult comp as well --

Nick Prendergast - *BBT Capital - Analyst*

Sure.

Christian Rothe - *Graco - VP, Treasurer*

And we obviously posted some nice numbers off of a 20% growth from the prior year. So we, clearly, as Pat said, we're interested in looking at order rates, and seeing the cadence coming in from our customer base, and what we hear from our operations, and we still feel like the demand levels are there. The expanded distribution based on what we have between the home center and the paint store channel obviously helps us, but that's been there for several quarters now. So we -- overall, we feel like we're in a pretty good market. And I think, also, just maybe to add another comment, if you were to take a look at some of the others in the space around the paint store channel and the home center channel, you'll see that they're



also experiencing some pretty good volume growth. Yes, [grey] equipment is outstripping the growth in paint [indiscernible] overall, but it's -- most of them would indicate that they consider that a leading indicator for their business.

Nick Prendergast - *BBT Capital - Analyst*

Yes, right. Okay. Well, thank you very much.

Operator

And we'll take an additional question from Mario Gabelli of Gabelli & Company. Please go ahead, sir.

Mario Gabelli - *Gabelli - Analyst*

I'm one of my analysts? Nice to chat with you Pat, Chris, Jim. And just cash tax rate as opposed to book, which you laid out in your press release and the statement -- by the way, great results and clarity of what your objectives are.

Pat McHale - *Graco - President, CEO*

Thank you.

Mario Gabelli - *Gabelli - Analyst*

Chris, that question is a simple question. This question is a simple question, then I'll get into a more interesting one. Your book tax you gave in the press release, and what you expected in the third and fourth quarters and what the impact of R&D, but what is your cash tax?

Christian Rothe - *Graco - VP, Treasurer*

The cash tax differential is not significantly much from what the book tax amount is.

Mario Gabelli - *Gabelli - Analyst*

Can you create a newco and do an IPO independent of a green light from the regulators on the liquid business? I mean, the text that you released on page 10 is pretty much the same as you've done before. You have an investment bank on retainer for two years to find -- identify potential buyers. Can you do an IPO of that business? Forget about the size for a second and then do an --

Pat McHale - *Graco - President, CEO*

The ultimate disposition of the business has to be approved by the FTC.

Mario Gabelli - *Gabelli - Analyst*

I know. But if you lob a grenade into their lap and wake them up, if you said, "I want to do an IPO and do 19%," and then do an exchange for the common, so you're buying stock back with pretax dollars rather than after-tax dollars, how would they react to that? Have you tested that water?



Pat McHale - Graco - President, CEO

I can tell you that their grenades are bigger than mine.

Mario Gabelli - Gabelli - Analyst

Darling, we understand the bureaucracy of this country. So much for creativity and creating jobs, I got it.

Pat McHale - Graco - President, CEO

Yes, no, we've discussed internally a variety of options, including that.

Mario Gabelli - Gabelli - Analyst

Yes, you've done it for 27 months. Thank you.

Pat McHale - Graco - President, CEO

You bet.

Operator

And it appears there are no further questions at this time.

Pat McHale - Graco - President, CEO

All right. Thank you, everyone, for joining the call, and we look forward to talking to you again in three months.

Operator

And this concludes our conference for today. Thank you for your participation. All parties may now disconnect.

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