GRACO INC., #4432429
GRACO INC. FIRST QUARTER 2011 EARNINGS CALL
April 28, 2011, 10:00 AM CT
Chairperson: Pam Steinkraus (Mgmt.)

Operator: Good morning and welcome to the First Quarter 2011 conference call for Graco Inc. If you wish to access the replay for this call, you may do so by dialing 1-800-406-7325 within the United States or Canada. The dial-in number for international callers is 1-303-590-3030. The conference I.D. is 4432429. The replay will be available through May 2, 2011.

Graco has additional information available in a PowerPoint slide presentation which is available as part of the webcast player. At the request of the Company, we will open the conference up for questions and answers after the opening remarks from the 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 1(a) of Exhibit 99 to the Company's 2010 Annual Report on Form 10-K and in Item 1(a) of the Company's Quarterly Report on Form 10-Q for the quarter ended April 1, 2011. 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.

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

Caroline Chambers: Good morning everyone. I'm here this morning with Pat McHale and Jim Graner. I will provide some comments on the financial highlights of our first quarter, and Pat will follow with some additional comments. Slides are available to accompany our call and can be accessed on our website. The slides include information about our consolidated financial results in each of the segments. After our opening comments, we will open up the call for your questions.

The sales momentum from 2010 continued into the first quarter of 2011. Net sales were 218 million for the quarter, up 32% as compared to the prior year with double digit growth in all segments and regions. Currency translation did not have a significant impact on the quarter.

Overall, volume increases drove improvements in gross margin rates and improved leverage on expenses. Operating earnings for the quarter as a percentage of sales were 26%, up from 20% a year ago. Net earnings totaled 37 million or $0.61 per diluted share.

Gross profit margin in the quarter as a percentage of sales was 57% compared to 54% in the first quarter last year. Higher production volumes fully absorbed fixed manufacturing costs in the first quarter of 2011, improving gross profit margins by two percentage points as compared to the first quarter of the prior year.

Material costs in the first quarter were slightly unfavorable as compared to the first quarter of the prior year offset by selling price increases. Material cost pressures are expected to continue throughout the year.

Operating expenses increased by 11 million or 19% compared to the first quarter last year. This increase includes an additional 8 million in selling and marketing. Product introduction, primarily in the contractor segment, accounts for approximately 3 million of the higher marketing cost.

The stronger business levels in Q1 this year drove prior levels of incentive accruals as compared to Q1 last year. Focused headcount additions in sales and marketing also contributed to the higher expense level.

The effective tax rate for the quarter was 34% compared to 34.5% for the first quarter last year. The rate this year included the benefit of the federal R&D tax credit which has not yet been extended in the first quarter of last year.

First quarter cash flow from operations was 14 million as compared to 16 million last year. Our working capital requirements increased in line with our increasing volume. Increases in accounts receivable were 29 million with days of sales outstanding remaining consistent with prior periods. Inventories increased by 11 million as our factories improved service levels on key products and international distribution inventories increase. Other primary uses of cash in the quarter included capital expenditures of 4 million and dividends of 13 million.

The first 150 million of the long-term debt that was previously announced was drawn down in March, and the proceeds were used to repay the revolving line of credit borrowing and the remainder invested in cash equivalent.

Our backlog continues to be strong, increasing 6 million from year end. Going forward we anticipate continued material cost pressures. Strong factory volumes and efficiencies should help offset high material costs. Our rate of incentive accruals was lower in Q1 as compared to Q4 of last year. With the strong growth in the later quarters of 2010, our comparable growth rate will become tougher and our ongoing incentive of accrual rate will reflect the Q1 growth rate only if we see that coming through in the actual growth rate.

We are expecting to return to the normal seasonal pattern of our business, particularly in the contractor segment. We expect Q2 interest to be approximately 2 million and expect to drive down the additional 150 million of the previously announced long-term debt in July.

We are beginning the regulatory approval process related to the acquisition of the Finishing Group of Businesses from ITW and currently anticipate the transaction to close in the third quarter of 2011. Transaction costs in Q1 were minimal but anticipate costs of approximately 5 million in Q2. Total transaction costs are expected to be in the $15 million range.

With that, I'll turn it over to Pat for additional comments.

Patrick McHale: Good morning. I'll begin with Europe where revenue increased 27% versus Q1 of last year. The sales increased at solid double-digit rates in Western Europe, Eastern Europe, the Middle East, and Africa, and were strong across all product categories. While overall European Q1 sales are still slightly below our pre-recession peak, sales in developing countries are now back above peak. We believe this performance reflects both the economic potential of developing markets and our significant investment in people and channel. Our adjustor of business in Europe performed well growing 24% versus the last year.

Contractor equipment sales in Europe increased 33% compared to Q1 of last year and surpassed our 2008 peak Q1 at constant exchange rate. New products contributed about half of the increase. Through the balance of the year, we expect residential construction in the region to improve modestly and commercial construction to be flat to declining.

Lubrication equipment continues to grow nicely in Europe off a small base and also exceeded our pre-recession Q1 peak at constant rate. We continue to be positive regarding our growth prospects for Europe in 2011.

Switching to Asia Pacific, Asia Pacific is off to a good start with 35% growth over Q1 of last year, and we had double-digit increases in both developed and developing countries and across most product categories.

Business in Japan was also up double digits, although we do expect some short-term negative impact from the earthquake this year and a likely positive impact in 2012. Note that Japan accounts for less than 3% of total Graco revenue.

In 2010, Asia Pacific significantly exceeded our pre-recession peak. We've invested heavily in people and channels during the past few years, and our 2011 plans reflect significant additional incremental investment for commercial people, customer support and training. We continue to be positive about our growth prospects in Asia Pacific for 2011.

Now on to the Americas. In North America, all segments were up double digit compared to last year. Our industrial segment continues to perform extremely well with double-digit growth in all major product categories. Strong markets include automotive, [inaudible], small aerospace, energy infrastructure and general industrial. Our residential insulating foam business also continues to grow well despite low levels of new home construction, as the market continues to adapt this technology.

The lubrication segment is off to a good start. We had double-digit growth in both our vehicle service channel and our industrial lubrication channel, with industrial lube growing faster. Operating margins for the lubrication segment continue to improve; however, the operating margin of 21% achieved in the global lube business in Q1 is expected to moderate into the high teens for the balance of the year as we continue to invest for growth.

In contractor North America, revenue grew strong double digits in both propane and home center. The home center growth was primarily driven by the product load associated with the expansion of outlets. This increase in channel presence should help home center volume all year.

Growth in the paint channel was driven by the continuing success of new products; however, we are also seeing early signs of improvement in base business. Although, end-market conditions in the U.S. remain very depressed, our field personnel believe that the glud [ph] of painting equipment in the market when housing crashed in 2007, may be reaching depletion. There's no way for us to accurately measure this, but order patterns in Q1 show encouraging trends in volume and mix.

Latin America had an excellent first quarter growing more than 40% off a small base compared to Q1 of last year. Automotive, [inaudible], infrastructure and natural resources markets continue to be very healthy.

In terms of outlook, going forward, comparisons become more difficult. We expect a quarter over prior quarter—prior year quarter's growth percentages to decline as we're approaching and, in many cases, exceeding our pre-recession peak. We expect global industrial market conditions to continue to be favorable for us this year and are particularly positive on the developing economies. Our investments in new products, new markets, and new distribution offer ample opportunities for growth.

We remain cautious about our base business prospects in the U.S. contractor equipment market; however, our investments in new products and channels, give us an opportunity for success in 2011 even with weak end-market condition. We expect the European and Asia contractor businesses will continue to perform well.

This concludes my prepared remarks. I now ask the operator to open the session to Q&A.

Operator: Thank you Sir. The question and answer session will begin at this time. If any participant would like to ask a question, please press the star, followed by the one, on your telephone. If you wish to cancel this request, please press the star, followed by the two. Your questions will be polled in the order they are received. There will be a short pause for participants to register for a question.

Our first question comes from Christopher Wiggins from Oppenheimer. Please proceed with your question.

Christopher Wiggins: Hi. Good morning.

Patrick McHale: Good morning.

Christopher Wiggins: Great quarter. The first question, did—could you just—how much of the growth in contractor year-over-year was from the new product stocking into the home center channel?

James Graner: Well, we expect that the new product—excuse me, the stocking into the home center channel in total was about 5 million. And, we're estimating that about one quarter to 30% it was the handheld item.

Christopher Wiggins: Okay, great. Thank you. And then, I guess, across the segments, can you comment a little bit on where your utilization stands right now? And, I guess, I'm wondering how much—how much absorption is less to capture as you kind of go through the rest of the year?

Caroline Chambers: At the point, we think our factories are pretty much back to the volumes that we were expecting to fully absorb our fixed manufacturing costs.

Christopher Wiggins: Okay, great. Thank you. And then, the last question, I guess, on industrial in particular. It doesn't look like there was any mixed benefit in the quarter. So, I mean is this kind of the new type of margin levels that you think is indicative to this type of volume? And, I guess, there was a bigger question and becomes, you know, is there any risk that customers see this kind of margin level and might push back a little bit, you know, as far as concerns over whether you're making too much money off of them?

James Graner: I'll answer the equation question first. For sure, we think this is a great operating performance as operating at peak factories. We do have some material cost pressures coming forward, but we also have some fair role trends on the efficiency and productivity side as well. So, we don't see that is a large head wind, but as something we should mention.

With respect to the end users, you know, we price for our intellectual property, we price for our features that we offer versus the competitors, and we don't see any pressures back from the field. People like our products because of the ROI they get from using it, saving material and labor. And, we're very comfortable with where we're at price-wise with respect to competition.

Christopher Wiggins: Great, thank you. I'll get back in the queue again. Great quarter.

Operator: Thank you. Our next question comes from Terry Darling from Goldman Sachs. Please proceed with your question.

Terry Darling: Thanks and good morning.

Patrick McHale: Morning.

Terry Darling: Hey, Pat, I think it was indicated by you on the contractor home center stock, you expected that to continue all year. Can you elaborate on that? And then I'm wondering if you might address what you think was going on from the standpoint of just this seasonal, you know, kind of, Q1 inventory build that sometimes happens? You know, it did seem, across the industrial space, that people were working inventories down very hard at the end of last year and may there be some normalization that would happen in the first half? Let's start with those two.

Patrick McHale: Okay. On the contractor side, you know, the inventory stocking in the home center channel will not continue all year. What's going to happen is that we've got more outlets in the balance of the year than we had last year, which will be helpful. You know, we picked up eight or nine hundred additional outlets, and so, now that those are stocked up, our run rate will have some—hopefully some tail wind because of that through 2011. So, I think that's positive for us.

On the question [talk over]

Terry Darling: Sorry, I'm sorry. Just to be clear on that. You're saying that 5 million is a good run rate, but you're not going to build from that. Is that what you meant?

Patrick McHale: No, 5 million is what the load was in the first quarter. So, we end up with expansion in the home center. We have to fill up some stores with more product, and we have to fill up 900 stores with the full product line and that got us 5 million. Now, instead of having—at one particular account, instead of having half their stores in 2011, we got all their stores for the balance of 2011. So, you know, I'm not making a prediction on what the run rate's going to be. I'm just going to say that we've got a lot more outlets in the last nine months of 11 than we did in the last in the last nine months of 2010.

Terry Darling: Okay.

Patrick McHale: So, what the run rate will be, we'll see now that we're stocked up. But, it should be good.

Back to your other question regarding inventory build. Yes, I don't really see any signs of inventory build either in our channel or at the end user had any significant impact on Graco in Q1. Our industrial channel partners typically stock only what they need to service the spare parts needs of the customers. Graco's business model is to maintain a significant inventory and finish good, then they ship it out typically in 24 hours notice. And, so big inventory swings don't happen much in our industrial business, and I don't think we saw any of that in the first quarter.

Terry Darling: Okay, and in terms of the, you know, what you often see in terms of a significant step up in margins in contractor Q1 to Q2. Anything different about either this year in and of itself or where we are in the cycle that would change that normal seasonal pattern in contractor margins?

Patrick McHale: I don't see any reasons that give anything different—different prediction for this year.

Terry Darling: Okay, and then, you know, maybe on the—across the—well, first, with the lube margins coming off a little bit here. What was the main reason for those stronger margins than what you're expecting with the balance of the year for lube? Was that just a particularly good quarter in Europe or something like that or?

Patrick McHale: There's been a couple little one-times that helped them otherwise they would've been in that, you know, 18, 19% kind of a range. And, that's really where we expected them to be this year, was in the high teens. We continue to invest in our industrial lube initiative for growth, and we continue to put a fair amount of resources into Europe and Asia where we're seeing some nice growth in lube. So, we're making sure that we're doing the right things to grow the top line. We're expecting operating margins in the high teens, and they just had a couple of blips to help them in the first quarter.

Terry Darling: Okay. One more and then I'll get out here. The—Jim, I'm wondering if you could help us with what—you know, if we held Euro dollar constant from here forward, what you think the translation effect would be on a four-year basis 2011 year-over-year on EPS or revenue or however you can help us with that?

James Graner: Well, it's a question that comes up from time to time. And I don't give point estimates with respect to it. I do indicate that last year in the second quarter, the Euro rate was 128, today it's 148. So, we will have some margin expansion from the Euro. Recall that the Euro represents about 16% of our volume. Another few percentage points coming from the Pound Sterling. So, it is a significant tail wind for us in the second quarter.

Terry Darling: Okay. Thanks very much.

Operator: Thank you. Our next question comes from Charles Brady from BMO Capital Markets. Please proceed with your question.

Tom Brinkmann: Good morning. This is actually Tom Brinkmann standing in for Charlie Brady. Just a couple of questions, the—also the absolute level of the backlog you guys had, you talked about how it's up $6 million quarter-over-quarter.

Patrick McHale: Correct. That's correct.

Tom Brinkmann: Right. Can you give us some context there? What was the absolute level of the overall backlog?

James Graner: I've got that here. So, our backlog is about 49 million at the current quarter end versus 42 million—43 million at the end of the year. It's a nice increase in contractor and in the industrial segments offset by a small decline in the lubrication segment.

Tom Brinkmann: Okay, great. And, can you talk about the material cost pressures? Can you quantify what, I guess, the head winds are going to be that you expect to be able to offset? But, you know, are you talking about 100 basis points, a couple hundred basis points there for the remainder of the year?

James Graner: Yes, I would say that's a general category for reduction in gross margins is in that 100 to 150 basis points. Before any of the other parts to the equation comes into play, again, the higher productivity and efficiencies our factories are achieving as we exceed or meet our capacity targets plus some additional pricing that'll roll through in the second and third quarter.

Tom Brinkmann: Okay, great. That's nice color. And then as far as the acquisition of the ITW businesses, is it fair to say that, I guess, your opportunity to expand margins there is pretty much based on new product introductions? You mentioned earlier in the call how you have intellectual property and your ability to differentiate products from your competitors. Is that pretty much you were hoping to add as opposed to, you know, selling synergies or operating cost synergies?

James Graner: I would say that our margin expansion from the ITW acquisition will come—opportunity will come in the manufacturing intellectual property. Mainly conversion of from [inaudible] to make and the few sparks that they require will get some cross selling synergies that are not significant.

Tom Brinkmann: Okay. And then last question, can you give us some guidance on the tax rate going forward?

James Graner: Yes, I—the full year should be in the 34% range.

Tom Brinkmann: Okay. Thank you very much.

James Graner: We shouldn't have the volatility we've had in the previous years, you know, with the government putting the R&D credit in and out, and the domestic production deduction credit is fully in place now. So, we should be good for the year.

Tom Brinkmann: Great. That's very helpful.

Operator: Thank you. Our next question comes from Matt Summerville from KeyBank. Please proceed with your question.

Matt Summerville: Morning. Just a couple questions on the contractor business. Pat, you talk about having more product in more stores, then you have a little bit of a tail off from the initial stock and with TrueCoat and ProShot. I guess, the net of those two, how should we think about the top line trajectory in contractor? Can you give us a little more granularity about the right way to think about that as we move through the remaining three quarters? And maybe also layer in there, you know, your view on whether or not those customers will add back a meaningful amount of inventory of what I'll call your, for lack of a better term, more of your legacy products.

Patrick McHale: Okay, yes. I can make a couple of comments. You know, first as Caroline mentioned in her comments, we anticipate that contractors more likely to look more normal from a seasonal selling standpoint and maybe it has the last couple of three years when things have been a little bit, kind of, up and down. So, in our view, is if you are looking for trends in contractor you'd be best off predicting, sort of, a normal seasonal curve, which would bode well for our outlook for the second quarter. We like the new products that we've launched for 2011. We do have to overcome the loads that we had in the second quarter of last year with the handheld which was about $9 million. But, we believe that's doable based upon the new product that we have and the fact that we will have some sales there as well.

So, you know in general I think we're feeling better about our contractor business despite not great end-market conditions. And the other interesting thing that we saw here in Q1, was that our—I'll call it our base business on legacy product, our large gas sprayers and our large electric sprayers that really were meat and potatoes of our business during good times. You know, they really died from 2007 through last year, and we're seeing some interesting signs of life in those product categories in the first three months of the year, and we're seeing a mix that looks more normal. And we, you know, in the last four or five years the mix has really shifted towards the low end part of the line. We think that was people being price sensitive, and we think it was also related to the big amount of sprayers that are sitting out—were sitting out there in the market when the housing market stopped. And so our—again, it's the short data points and I'll likely get some more months behind us, but our view right now is that potentially the inventory that's out there in the channel has been soaked up since 2007, and we may see border patterns on our high-end contractor equipment start to look more normal as well as a more normal seasonal pattern. And, all those things would be good for both volume and profitability for contractor going forward. So, I think there's some slight reasons to be optimistic over and above the fact that we've got some interesting new product and that we've got additional channel.

Matt Summerville: With regards to the 9 million you mentioned for Q2, do you have the figure for Q3 as well? Because I thought that original stock had a pretty profound impact on both quarters last year.

Patrick McHale: Actually Q3 was about 12, and I believe Q4 was about five to six.

Matt Summerville: And do you think, again based on sort of the data points you just shared, do you think growing above and beyond that are backfilling, maybe is the better way to term it? Do you feel comfortable about more than backfilling in Q3 and 4 as well?

Patrick McHale: Well, I never feel comfortable about anything because it's not my nature. I don't think it's going to be like falling off a log, but we do have good product that we're launching this year. We did sell about 8 million of handheld in the first quarter. Just for full disclosure, a chunk of that went into the home center load, which Jim talked about, which was probably in that 1.5 to $2 million. And then we also have another version that we launched that we got some play on. But, you know, we're still seeing revenue on that product line, and I think that we have an opportunity to grow here over the course of the summer.

Matt Summerville: As these new product launch support costs ad campaign, does that either tails off a little bit in aggregate that expands. How should we think about the incrementals in this business relative to Q1? You're at 32% [inaudible] in the first quarter, how should we think about those incrementals moving forward given some of the dynamics we're talking about here?

James Graner: Well, Matt, you know, we're forecasting our seasonal trends to return in the contractor business. You know, our first and fourth quarters are always our lowest profitability. You saw the 16% [inaudible] in the first quarter. So, the seasonal pattern will drive that higher on a normal basis and then, again, we should see a flattening, if not, an absolute decline in the store set expense in the second quarter and then of course by the third quarter, that's over. So, you can expect and you can model that our contractor operating profitability will increase in the second and third quarter.

Matt Summerville: Thanks Pat. Thanks Jim.

Operator: Thank you. As a reminder, if you'd like to ask a question, please press the star, followed by the one, on our telephone. If you wish to cancel this request, please press the star, followed by the two.

There are no further questions. I will now turn the conference over to Pat McHale.

Patrick McHale: All right. Thank you everybody for their time this morning and have a good rest of your week.

Operator: This concludes our conference for today. Thank you for participating and have a nice day. All participants may now disconnect.

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