Conference Transcription

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Conference title	**:**	**Graco Inc – 1st Quarter 2012 Earnings Call**

CONFERENCE DETAILS

Conference Date:	26 April 2012
Conference Time:	10:00 Central Standard Time
Conference Duration:	Approximately 53 minutes
Chairperson:	Pam Steinkraus
Speakers:	Pat McHale Jim Graner Caroline Chambers

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KEY:	
words in bold	Unsure if words heard correctly - please check
??	Words could not be distinguished
(Inaudible - ….)	Words that are entirely inaudible for the specified reason

ACT Operator

Good morning and welcome to the 1st Quarter 2012 Conference Call for Graco Inc. If you wish to access the replay this call, you may do so by dialling 1-800-406-7325 within the United States or Canada. The dial-in number for international callers is 303-590-3030. The conference ID is 4530277. The replay will be available through 30 April, 2012. 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 question 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 purpose of the safe harbour 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 and Exhibit 99 to the Company's 2011 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 to the time they are made. The company undertakes no obligation to update these statements in light of new information or future events.

If any participant has difficulty hearing the presentation please press *0 on your telephone for operator assistance. I will now turn the conference over to Caroline Chambers, Vice President and Controller.

Caroline Chambers

Good morning, everyone, I am here this morning with Pat McHale, Jim Graner and Christian Rothe. I will first provide comments on our first quarter financial results and then follow with a brief discussion about the acquisition of the ITW finishing businesses. Slides are available to accompany our call and can be accessed on our website. The slides include information about our consolidated financial result in the first quarter in our usual format. We have also included several additional slides about the acquisition and the new finishing businesses including some historical financial information for the powder and liquid finishing pieces of the business for the first quarter and last year based on management and accounts provided by the seller.

Although we are providing some top level more information about the liquid finishing results in the slide, access to detailed operating information for the liquid finishing businesses is limited as a result of the hold separate agreement with the FTC and we do not have detailed information on current liquid finishing operations. Graco sales of $234 million for the quarter were 8% higher than the strong first quarter last year with growth in all segments and geographic regions.

Changes in currency translation rates did not have a significant impact for the quarter. Net earnings totalled $35 million or $0.58 per diluted share for the quarter. Earnings were 5% lower than last year. Higher cost and expenses this quarter particularly for product development of about $2 million, pension of $1 million, acquisition transaction cost are $4 million and additional interest of $3 million more than offsets the growth and sales and the strong growth margin.

Gross profit margins as a percentage sales were 56.5% for the quarter, slightly lower than last year. The effect of higher material cost was partially offset as we began to see realised price increases and improved factory efficiencies. We expect that both realised pricing and factory efficiencies will continue to improve going forward in 2012.

As noted earlier, product development expense increased by $2 million in the quarter as compared to last year mainly due to increased headcount and project expenses. About half of the increase is in the industrial segment.

General and administrative cost increased by $5 million from the prior year including $4 million of acquisition-related costs. We expect transaction and related legal costs of approximately $8 million in the second quarter of this year. Operating earnings were also affected by an additional million of pension costs as compared to the prior year. For the full year 2012 we expect pension costs to increase by approximately $5 million from the prior year. We also expect to make a voluntary contribution to the US funded pension plan of approximately $5 million later this year.

Interest cost increased by $3 million compared to last year with the full $300 million of private placement debt in place for the first quarter of this year. We expect interest expense to be approximately $6 million in the second quarter. The effective tax rate of 34.5% for the quarter is higher than the rate for the first quarter last year due to the expiration of the federal R&D credit. Net cash provided by operating activities was $23 million for the first quarter as compared to $14 million for the first quarter last year. Although inventories increased by $5 million and accounts receivable increased by $21 million from year-end due to higher sales, as a performance metrics it improved. Capital expenditures were $8 million for the quarter and we paid dividend of $13 million.

As noted in earlier communications we entered into an agreement with the FTC at the end of March under which we were able to close the $650 million cash acquisition of the ITW finishing businesses. Under this arrangement we are able to manage and consolidate the powder finishing business but the liquid finishing businesses must be held separate. The independent structure will remain in place until the FTC issues a final decision and order that identifies the products, businesses and/or assets that are required to be divested and a divestiture is completed. A $450 million revolver was put in place in 2011 to finance the transaction. The credit agreement was amended to allow extension of the revolver until March 2017 and to eliminate the requirement for additional permanent debt beyond the $300 million private placement debt that was put in place during 2011. Available cash balances and borrowing of $350 million under the revolver were used to complete the purchase of the finishing business.

During the hold separate period, while the FTC completes their review, Graco does not have a controlling interest in the liquid finishing businesses. Consequently, the company's investment in those businesses will be recorded at cost and the financial results will not be consolidated. Income will be recognised based on dividends received from current earnings.

Slide 11 of our webcast slide deck provides some high level revenue, operating margin and EBITDA information with an unaudited split between powder and liquid finishing operations. Note that these figures are from management accounts and as they are unaudited, we have used rounded figures but want to provide a better sense of the operations and cash flow for each of the pieces. We did make a change to this slide overnight. The current slide notes overall EBITDA of $80 million which is before management fees.

With that, I will turn the call over to Pat McHale.

Pat McHale

Thank you, Caroline. Good morning, everyone. These are our first public comments since we closed the purchase of the finishing brands from ITW. Before getting into our details for the quarter I want to take a moment to talk about the acquisition and the scenarios that could unfold over the next few months. First, I would like to welcome the employees and distributors of the ITW finishing brands to the Graco family. We are thrilled to have all of you on our team and everyone in our organisation looks forward to working with you and making all of our businesses stronger.

To remind everyone, we are allowed to close and to begin operating the Gema powder finishing business immediately after closing on 2 April. This is a very positive development for Graco as this business is a great strategic fit. I will spend a few minutes talking about the Gema powder finishing business. Graco has not had a presence in the powder finishing market historically. We view this as an outstanding addition of product capabilities to Graco's existing liquid finishing line-up and strategically important from a material development point of view. The Gema brand is a leader in the powder finishing market and Gema's powder finishing technologies have proven quality and performance. This business has a strong base of customers, distributors and installations upon which we can build. Powder finishing is a common and growing application in emerging markets and Gema is capitalising on this growth. The end user profile for many powder applications is different than for the traditional Graco liquid business and will give us some diversification.

For these reasons and more, we are excited to have the acquired Gema in this transaction. The other two-thirds of our acquisition from ITW consisted of four brands focussed on the liquid finishing market. As we disclosed on several occasions during the past year, the liquid finishing businesses were and are the subject of the FTC's anti-trust review. During the first quarter, Graco made a settlement offer to the FTC that we believe satisfies each of the concerns that they detailed in their complaint which was filed in late 2011. The terms of the settlement offer remain confidential while the FTC considers it but I will tell you that it is a material subset of the acquired liquid finishing businesses. Since the order from the FTC to hold the liquid finishing businesses separate came down in late Q1 the FTC has been evaluating our proposal and vetting it with the market. We don't have a lot of visibility to the process unfortunately so I can't give you much for details. I can tell you however that the vetting process includes discussions with end users, distributors and competitors.

The FTC's objective is to ensure that the market remains competitive post-transaction. We strongly believe that our proposed settlement meets this objective. However the FTC will make the final determination regarding the extent of divestiture required. Once their final decision and order comes down, we will have 180 days to divest the required operations. Graco expects to be divesting a portion of the acquired businesses, we just don't know to what extent. We will keep our investors updated as developments warrant. No one other than the FTC is in a position to know exactly how long this process will take. In the meantime the cash that builds within the hold separate businesses is the property of Graco and available to us. We are very confident in the cash flows of liquid finishing and it will be cash flow accretive during this timeframe.

Moving on to the first quarter, broadly the first quarter came in right where we expected. As you know we have high expectations for 2012 with growth in all segments and regions. We had a very robust first quarter in 2011 on sales, gross margin and operating margin. I am happy with how Graco performed in Q1 against these difficult **comps**. As Caroline highlighted our gross margins declined slightly from Q1 of 2011 which was the high point for our gross margins last year. However our gross margins improved sequentially more than 200 basis points from the fourth quarter of 2011 and I believe there is an opportunity for improved gross margins in the coming quarters. Looking at this year's Q1 results, we had some limited promotional activity related to product lifecycle that puts some pressure on our gross margin flow through and price realisation is generally a bit lower in Q1 due to timing issues.

Compared to Q1 of last year we also had the expense headwinds Caroline outlined for you, incremental pension cost of $1 million, acquisition cost of $4 million, and interest expense of $3 million. All told, these items reduced our after tax net income by about $5 million. We also spent $2 million more than last year on product development cost. As our long-term investors know we view these costs as an investment that will yield future revenue and earnings for Graco. We continue to add engineering teams to our industrial segment as the opportunities to grow our worldwide base in industrial applications are very attractive. I am happy to make these investments as it is one of the best deals that we can get. When we roll it all together we feel very good about Graco's overall results in Q1.

That said, as we dig further into the performance, we had some areas that were stronger than expected while others underperformed. I will underscore each of these areas as I go through the segments and regions. Beginning with the contractor segment, sales grew at 3% worldwide in the first quarter. We had difficult comps in this segment in the Americas from the first quarter of 2011 where we shipped $5 million in new store sets as we expanded our presence with one of our home centre customers. Despite the difficult comp we grew sales in the Americas by 3%.

I know that many of our investors are interested in the Americas contractor sales, so I want to give a few more data points here. First, sales to our paint channel contractors were up double digits in the quarter. This is a continuation of a trend that we saw last quarter and is consistent with what some of the major players in the construction market have reported publicly. There is no doubt that the early spring was a help to Q1 sales for Graco. However some of the statements made publicly by our customers would indicate that the lift in sales has not been isolated to exterior coatings in the northern geographies. That would indicate that there is more to the market uptake than just weather.

Moving on to Europe, contractor first quarter sales on a constant currency basis were 1% less than the prior year. I mentioned in last quarter's call that I was cautious on the European contractor segment particularly for the first half of 2012 and against that backdrop I am satisfied with the performance in Q1. Asia-Pacific contractor sales grew at a double digit pace in Q1. We continue to focus on end user conversion and we have a solid line-up of new products in 2012.

Switching now to the industrial segment, the industrial segment posted double digit growth for Q1 and a new record for Q1 sales for this segment. We did see some variation between geographies which I will comment on. The Americas was the strongest growth region in Q1 reflecting ongoing demand from a broad base of domestic end markets including general, industrial, construction and automotive. Industrial demand in the Americas was a bit stronger than I expected and our outlook is for growth to continue through 2012.

European industrial sales also grew at a double digit pace excluding FX for the first quarter. Frankly, with the macroeconomic environment and construction market as challenging as it is in Europe, this performance was very strong. Our team in Europe remains optimistic about prospects for the remainder of 2012 although I am somewhat cautious due to general economic environment. Uncharacteristically, Asia-Pacific posted the lowest growth rate of the regions in Q1. Results were variable by country and product line. China in particular was softer than I expected. I still expect double digit growth for Asia-Pacific in 2012 but will be closely watching order rates.

We saw some pressure on operating margins in the industrial segment in Q1 where the prior year was quite strong. I believe that we will continue to expand margins as the year progresses.

Next up is the lubrication segment. Lubrication sales grew double digits again in the first quarter as a segment posted another Q1 sales record. Growth was outstanding both in Asia-Pacific at 25% and in the Americas at 14%. Overall, worldwide sales growth was 14% as we continue to see great demand in both vehicle services as well as our industrial lubrication product lines. Sales declined in our European lube business but this is from a small base of $2 million in sales, so minor fluctuations in volume and time and can have a significant impact on the percentages. I anticipate better performance from European lube as the year progresses. Operating margins for the lube segment also expended in Q1 getting us back into the low 20s. Our target is to maintain this level of operating margin for the full year. Long-term, we believe this business can get into the mid 20s as we continue to drive volume and plant level efficiencies through the operation.

A few comments about Europe – on a constant currency basis, sales in Europe grew by 6% in Q1. Looking at the varying growth rates within the region, Southern Europe remains the most difficult where sales declined 4%. Countries in Central Europe grew modestly in the quarter while Northern Europe grew only slightly. Overall for Western Europe, growth was only slightly positive. In the remainder of our European region which includes Eastern Europe, Russia, the Middle East and Africa, growth rates were in the teens. Russia led the way with the Middle East also posting nice growth.

My next commentary is related to Asia-Pacific. The contractor and lubrication businesses had nice growth in the quarter showing a strong return on the investments we made in resources in emerging markets for these product categories. As previously mentioned, our industrial business was a bit soft however I still believe we will see double digit growth for the year. Every segment within this region posted record first quarter sales reflecting that this remains an outstanding story.

Now for some comments on outlook. As stated at the outset of the year, we are planning for solid growth in 2012. With one quarter under our belt, the story hasn't changed although the individual contributions to a growth may vary somewhat. Our new product pipeline is healthy, our factories are performing well and the investments we made in people and resources in Asia and Europe give us more horsepower for 2012. We still feel comfortable with the overall expectations for 2012 that were discussed in this call a quarter ago. We believe that our lubrication segment will grow double digits in 2012, industrial segment will grow at a low double digit pace and the contactor segment will be in the single digits, all of these from a record level performance in 2011. This outlook excludes growth from acquired businesses. Overall we expect the finishing brands to grow in the mid to high single digit rate for 2012.

This concludes my remarks. Operator, we are ready to open the call to questions.

ACT Operator

Thank you. The question and answer session will begin at this time. If you would like to ask a question please press *1 on your telephone. If you wish to cancel this request please press *2. Your question will be taken in the order it is received. Please standby for your first question.

The first question comes from Charles Brady of BMO Capital Markets. Please go ahead sir.

Charles Brady – BMO Capital Markets

Good morning, guys.

Pat McHale

Good morning.

Charles Brady – BMO Capital Markets

Commenting on industrial in the Asia-Pacific outlook, what gives you the confidence that this business is going to have a rebound for the rest of the year on Asia-Pacific? You have got some pretty tough comps over the next two or three quarters.

Pat McHale

Yes, we do. We also have a strong new product pipeline. We have done a lot in terms of expanding both our sales coverage and our distribution channel and we have of course been in close contact with our operating people over there and we are taking a look at how we think the year is going to play out. We still feel pretty good about it.

Charles Brady – BMO Capital Markets

Can you give us a sense of – in Q1 what exactly drove some of the softness in Asia-Pacific in industrial?

Pat McHale

It was variable. The last couple of years, every product line, every geography has been kind of on a double digit **term**. We saw more variation in the first quarter with some of the countries performing very well and some not so well. In particular I called out that China was a little bit soft. So it's not a situation where we are seeing a general softness across Asia-Pacific. We just saw some sort of spotty performance in some countries and in some product lines.

Charles Brady – BMO Capital Markets

OK, and then on your outlook, in your commentary across the three segments you said it does not include finishing. I just want to be clear – does it include the powder business that you do have under control now or not?

Pat McHale

It does not.

Jim Graner

Jim Graner. Just to clarify Pat's comments on China, China did grow in the first quarter. The softness is the fact that it didn't grow double digits.

Charles Brady – BMO Capital Markets

OK. That's helpful, thanks. On product development cost, do you expect to kind of ramp it up at the current level for the rest of the year or was there kind of front-end loaded for new product development?

Caroline Chambers

This is Caroline Chambers. I am not saying that there is necessarily a great amount that is front-end loaded. We did put in place a few more teams and the **price** expense can vary from quarter to quarter.

Jim Graner

Our projection is in $45 million, $46 million spend for the year.

Charles Brady – BMO Capital Markets

OK. Great, thanks.

ACT Operator

The next question comes from Terry Darling of Goldman Sachs. Please go ahead, sir.

Terry Darling – Godman Sachs

Thanks, good morning everyone.

Jim Graner

Hey, Terry.

Pat McHale

Good morning.

Terry Darling - Goldman Sachs

Guys, I guess first on the ITW impact, I am wondering if you can, Jim, maybe lay out for us how the results are going to look in the second quarter and beyond given the unique structure here? Number one. Number two – Pat, can you speak to timing at all on the FTC? I realise that's a tough question but I think people are looking at that 17 July court date wondering if that's still something to keep an eye on? And then lastly on the ITW dynamic, is there any kind of minimum longer-term accretion type numbers we can talk about? Can you in any way refresh the comments you made about a year ago now with regard to the level of accretion? Those thoughts would be helpful.

Jim Graner

Right, Terry, this is Jim. I will go first on your question on accretion and I will talk to 2013 and then I will come back to the second quarter. If you project EBITDA in 2013 between $25 million and $30 million and you take a pro rata share of the financing cost, so $220 million over the $650 million total purchase price, you attribute about $8 million in interest expense to that EBITDA stream and while we do not have final figures, if you estimate that the D&A is in the $10 million kind of range, it should be accretive about $0.10 plus or minus. Again as we get final valuation numbers and final depreciation, amortisation numbers, we will share those with you which we expect to get in the first part of June.

With respect to the second quarter, we have called out $8 million in transaction cost. Those are all round fees, so they are accounting fees, attorney fees and banker fees. And if you are estimating we'll have some one time cost for asset write-ups particularly on inventory, you are going to see a significant headwind on pre-tax charges in the quarter for about – I will put in a number of $10 million to $15 million, hopefully closer to the $10 million than the $15 million. But that's all the clarity we can give today because we have not got the final appraisal work.

Pat McHale

All right so I will talk a little bit about your question on timing. Just to be really clear, there is not going to be any trial date in July. When we were given the July date for trial in the court system here, that was based upon if we didn't close the transaction and if we continue to fight this thing in court. We did close the transaction under the agreement that we communicated with the FTC and this hold separate agreement is really the end of the road here. The FTC is going to make a decision on liquid finishing in terms of what we need to do and we are going to follow through and do that. So there is not going to be any court date, there is not going to be any trial.

In terms of the timing, we don't have a lot of clarity to that. I would hope that some time in the next two to three to four months we will get a decision, an order from the FTC. But we don't control that timing and I am assuming that depends on a variety of factors including what else they are working on.

Terry Darling - Goldman Sachs

OK, that's helpful. And Jim, I guess back on the detail you provided also helpful there, a couple of follow-ups. The $10 million of D&A, the powder EBITDA stream, is that just D&A or does that include an assumption on purchase accounting adjustments and so forth or was that the subsequent point you were making that you are still trying to finalise that number and we will hear that I guess down the line?

Jim Graner

Yes, that assumes that all the purchase accounting adjustments flow through in the P&L in 2012. When we use that term I refer to the inventory and other R&D kinds of write-ups that are there, generally amortised over a quarter or two, so it should be complete. We should share with you that depreciation in the business we are acquiring was less than $1 million. That's why in the slides that you see, there is no difference between operating earnings and EBITDA, just to clarify that point. And again, this is not – I am not trying to lay out the incremental improvement because in the first quarter of this year we had some interest expense. What I am sharing with you is an allocation of interest expense in total for this business. We also had some one time cost in the first quarter. So don't view the $0.10 as an incremental number. It is really the profitability of the powder on a stand-alone basis.

Terry Darling - Goldman Sachs

Right, and subject to variances around what you sell the business for and how it performs and you are not layering in any synergies, cost out and so forth there is well, correct?

Jim Graner

Correct. The whole accounting for whatever we dispose of with respect to the liquid part that is in the held separate account is outside of this conversation.

Terry Darling - Goldman Sachs

OK. Coming back to how the cash from the finishing business will be dividended back to I guess the company in the second quarter, is there any way to gauge how that number might look at this point or how it might compare relative to the $10 million to $15 million as the pre-tax charges you called out? Any way to scope that for us?

Jim Graner

It is my intent and again this is subject to approval of the trustee on the hold separate is to dividend a portion of the cash balance increases in those businesses in the next nine months. We hope to make that at least equal to our increase in interest expense or the interest expense with respect to that $400 million that we have invested there and any incremental cost. I would like the P&L on a net basis to reflect the benefit of the powder business and zero cost for hold separate on the liquid side. My estimate is that's around $15 million to $20 million on an annual basis so you will see other income with respect to dividends, three quarters of that and of course on the gross amount flowing through to interest expense.

Terry Darling - Goldman Sachs

OK, that's helpful. I will get back in queue then.

ACT Operator

The next question comes from Liam Burke of Janney Montgomery Scott. Please go ahead, sir.

Liam Burke – Janney Montgomery Scott

Yes, thank you. Pat, now that you have bought in the powder coatings business, obviously the operating margins are below the normal industrial Graco margins. Are there a lot of customised systems within that product line which hold back margins or is it more like the Graco traditional, more standardised product?

Pat McHale

It's probably a little bit of a blend. It's not a lot of what I would call – at least what we would call at Graco pure custom systems. They tend to be more configured systems. They have got standard reciprocators, standard guns, standard controllers and then the customers will typically do a fair amount of mixing and matching. Of course they do get involved on the boost side and with some of the powder reclamation equipment which is I am sure I don't know what to guess at this point for sure but it is likely to be a lower margin business than the core pumping products. We get a little bit to learn on that side of the equation.

What I look at our opportunity with the powder business, the first thing we want to do is protect revenue. We don't want to go in and do anything that's going to harm the revenue stream. The business is already a pretty darn good business. So we are going to understand that and we are going to take a look at opportunities that we can leverage that within Graco channel or Graco customer base around the world. And then from a manufacturing perspective I do believe there are opportunities for us to do some of the work that they buy on the outside. They tend to be more of a design and assemble operation. And of course we are heavy in the precision machining, so I think there is going to be some opportunities there. But it is going to take us some time to sort that out.

Liam Burke – Janney Montgomery Scott

Sure, great. Thank you.

ACT Operator

The next question comes from Mike Halloran of Robert W Baird. Please go ahead, sir.

Mike Halloran – Robert W Baird

Morning, everyone. Excluding the acquisition cost at this point, what would you guys think is a pretty reasonable corporate expense run rate at this point?

Jim Graner

I think we are in – trying to ?? here - in the $36 million I believe off the top of my head is the underlying run rate. Again, part of that is with respect to the increased pension cost this year of $5 million.

Mike Halloran – Robert W Baird

I am asking because you had about $4 million of that $9 million corporate expenses this quarter was related to the acquisitions. You kind of net that out at $5 million. Just trying to figure out – based on your commentary it does not sound like that $5 million is the right number to think about the base excluding the corporate expense then, I mean excluding the acquisition related expense?

Jim Graner

I was talking on the growth base. What you are referring to is the unallocated –

Mike Halloran – Robert W Baird

Yes, the unallocated.

Jim Graner

That's more in $3.5 million kind of range.

Mike Halloran – Robert W Baird

$3.5 million, OK, that makes sense. Just to clarify a comment that Pat made on the industrial margins. You said you expect those to trend up. Were you referring on a year-over-year basis as we work through the year or were you saying trend up from 1Q levels through the rest of the year?

Pat McHale

I was referring to sequentially.

Mike Halloran – Robert W Baird

OK.

Pat McHale

I think there is some opportunity for us to realise a little bit more price going into the next three quarters and also our factories continue to run well. So assuming that the demand stays where we think it is going to stay, I think there is some upside opportunity.

Mike Halloran – Robert W Baird

OK, that's encouraging. I am assuming then you are referring to that on an organic basis –

Pat McHale

Correct.

Mike Halloran – Robert W Baird

Not inclusive of – OK, that also makes sense. And then, press release you guys referred to some new product pipeline in the back part of the year. Any way you could talk about that either qualitatively or quantitatively what types of products you guys are putting on the marketplace and type of impact you think that might be able to have?

Pat McHale

I don't want to talk about product releases for the second half just from a competitive standpoint. But we started ramping up our product development a few years ago and it has really been a nice contributor to our growth in 2010 and 2011. And when I look at 2012, particularly in the contactor, there new product efforts are a little bit more skewed towards the second half of this year than normal. A lot of times we end you with our big launch for contractor in the first quarter of the year and that's not true this year. But overall, I feel like our new product development pipeline is going to contribute like it has the last couple of years and I would rather not get specific on the product.

Mike Halloran – Robert W. Baird

Makes sense. Appreciate the time.

Jim Graner

Mike, I need to correct my comment or expand my comment relative to the unallocated corporate expense. The $3.5 million run rate is before the financing costs – incremental financing costs on our pension expense. With that, for this year it is more like $5 million a quarter.

Mike Halloran – Robert W. Baird

OK, that makes sense.

Jim Graner

I should comment that we have a nice performance in our pension assets for the quarter. We grew in excess of $20 million. Of course we don't reflect that growth in our P&L until next year and hopefully we can hold on to that.

Mike Halloran – Robert W. Baird

And I am assuming that's why the planned pension contribution jacked down from $10 million to $20 million last quarter to down to that $5 million range?

Jim Graner

Exactly, yes.

Mike Halloran – Robert W. Baird

Appreciate it.

ACT Operator

The next question comes from Kevin Maczka of BB&T Capital Markets. Please go ahead sir.

Kevin Maczka – BB&T Capital Markets

Good morning.

Pat McHale

Morning.

Kevin Maczka – BB&T Capital Markets

Can I just ask two more questions to clarify things on ITW. The $8 million in cost that you are expecting in Q2 which I think Jim said maybe north of $10 million actually, do those continue going forward or is that sort of one time fees that deal with the transactions that are now gone? And did you say that the liquid piece will impact the P&L positively even though it is not integrated to the tune of about $2 million which offsets the sequential increase in the interest expense? Did I get that right?

Caroline Chambers

This is Caroline. Maybe I will take the first part of this to begin with. That $8 million really refers to a lot of the outside costs we are going to have as we just try to wrap up the legal transfer of these assets and accounting fees and valuation fees associated with that as well as the costs associated with the continuing review work. That's kind of outside cost there. **Certainly** to be consistent with the costs we have had in earlier quarters. We are seeing that we do have the ability to recognise income for the liquid finishing part to the degree that we can declare dividends from current earnings. So we are having to take a look at that and that can also affect a little bit the timing as to when we can recognise that income. But obviously it'd be our desire to recognise that to the extent that we do have those financing costs.

Jim Graner

Kevin, it depends on how you look at the interest expense we had last year. What I would like to do, again subject to approval is the dividend enough income from these entities out to cover the financing cost, the $400 million and the incremental cost we have and will incur monthly as to the hold separate. So if you are looking at it incremental to last year, your $2 million per quarter is good. If you are looking at it just with respect to the transaction in and of itself, it should be a net. I know it's complicated but the whole discussion around this is complicated.

Kevin Maczka – BB&T Capital Markets

No doubt about that.

Jim Graner

Again, we expect to distribute probably around one-third of what the operating earnings are. So there will be a cash build up in these businesses, roughly two-thirds of their net income which again will come into the equation when we ultimately dispose of it or we ultimately put into our consolidated operation.

Kevin Maczka – BB&T Capital Markets

OK. And then back to the core business on the commentary around Asia, can you just give some colour around the cadence if you will to the extent that you are adding more distribution there because I think with the headlines coming out of China and elsewhere, it's understandable to see some slowing in a short cycle business like yours but I would think maybe with the pace that you are adding distributors there, you may be able to still far outpace any underlying growth rate that's there? Can you just comment a bit more in that?

Pat McHale

I will talk to you about the distributor adds. Jim can make any comments if he wants to on the pace question. But from a distributor add standpoint, that's a sort of regular ongoing activity for us over the course of the last three or four years, so it's not a ramp. We added distributor. Typically we have to do a fair amount of training to bring that person up to speed. For example, an industrial distributor might do $150,000 in purchases from Graco their first year and they might do $350,000 in the second year and $0.75 million in the third year. That's sort of a nature of the beast in terms of developing our distribution channel. And really what will contribute in 2012, there is lots of our efforts from 2010 and 2011 and the work that we are doing this year then will help contribute going forward.

Certainly when you think about our growth strategies, we believe we get incremental growth on new products, we believe we get incremental growth by targeting new markets and we believe we get incremental growth through the establishment of our distribution channel and that all those things provide us opportunities to perform better than the underlying market. However, that doesn't make us immune to changes in economic conditions. We would expect that over the cycle we outperform the underlying manufacturing growth rates in a place like China but if it speeds up or slows down, we certainly will move somewhat in tandem with that. I don't know if I answered your question or not.

Kevin Maczka – BB&T Capital Markets

No, that's very helpful, Pat. Thank you.

ACT Operator

The next question comes from Matt Summerville of KeyBank. Please go ahead, sir.

Matt Summerville – KeyBank

Just another question, Jim, on dividend mechanics from the liquid finishing businesses, that $15 million to $20 million that you guys are kind of hoping the trustee OKs to formally shift over to Graco, is that $15 million – how does the tax mechanics work on that $15 million to $20 million because coming out of the liquid businesses, that would be an after tax number I would imagine? So can you just talk through that briefly.

Jim Graner

Again it qualifies for the dividend exclusion at the corporate level, so there will be no incremental tax at the Graco level. Again that's part of the detail that we need to figure out. Just to clarify, this is not a shareholder dividend. This is an inter-company dividend. To the extent of course they are coming from US entities, they have the exclusion and to the extent they are coming from foreign entities, they will bring along foreign tax credits. Expectation is there should not be any incremental taxes at the Graco level.

Matt Summerville – KeyBank

Got it. And then, Pat, can you just comment a little more may be by geography in terms of what you've seen over the last couple of months in terms of order tempo January, February, March and may be what you've seen thus far in April? Specifically whether or not you've seen kind of your Asia business incoming order rates bottom out there or whether you feel there is additional deceleration?

Jim Graner

Matt, I will handle that question. With respect to geographies, North America, the trend continues, solid growth and we expect that positive to come. Europe and Asia-Pacific, we don't have much visibility. We are three weeks into April. But we are seeing sequentially in March and April a slight improvement in both weekly order rate from Europe and slight improvement in the weekly order rate sequentially from Asia.

Matt Summerville – KeyBank

And then can you may be also just lastly talk about in the contractor business how you guys are feeling about channel inventories in both the paint and home centre side of things? And then I think you mentioned your paint centre business was up double digits. Are you still seeing that net improvement in mix or those ASPs in sell through improve relative to either sequentially or a year ago?

Pat McHale

We feel pretty good about the inventory levels in contractor channels and specifically I am referring to the US where we get some of the out of door sales data. Our customers are selling the product and it's moving through so I don't see any big disconnect between what they are buying and what they are selling and I think that that is generally good news for us. And as the business continues to improve here over the next few years, I would expect that they will increase their stocking levels. But I think their stocking levels are pretty appropriate for where they are at today.

Mix and again I am going to specifically talk about the North America propane mix. Mix was a little bit interesting in the first quarter. We had seen a nice mix shift starting about a year ago towards moving higher a value units in our propane contractor and we continue to see that here in Q1 with nice double digit increases on our contractor units. But we also had a really significant increase in Q1 at the low end of our electric line. We really believe that that is some share performance that we had here in the first quarter in terms of getting the customer's wallet and getting them to put some of our smaller electrics in stock in preparation for the painting season in lieu of our competitor. That created a little bit of an interesting situation in contractor that's different from the last year. But my guess is going forward into the second and third quarter, that probably straightens itself out and I think that could give us a little bit of upside potential on gross margins in contractor going forward.

Matt Summerville – KeyBank

Thank a lot, guys.

ACT Operator

As a reminder if you would like to ask a question please press *1 on your telephone. To cancel this request please press *2.

We have a follow-up question from Terry Darling of Goldman Sachs. Please go ahead, sir.

Terry Darling - Goldman Sachs

Thanks. Maybe following up on the contractor comments there, Pat, the negative mix that you had in the first quarter if we were to also strip out the impact of the one-time sale which I think you indicated was $5 million at the revenue line, I think you had said in the past it was like $2 million at the profit line but maybe I could get a refresh there **like** your margins – your profit dollars excluding those were actually down year-over-year. Is that correct?

Jim Graner

No, the profit margin improved. I think on page 15 and 16 of the slides the company ?? you can see that our operating earnings grew from 16% of sales to 17% and revenue leverage on the next page in round numbers went up $1 million on a $2 million increase. On unrounded basis, the leverage percentage was over 80%. Operating margins improved significantly with respect to the percentage of sales and they grew 13% in dollars on a 3% increase in sales.

Terry Darling - Goldman Sachs

Maybe the way to ask the question is just the profit impact related to the $5 million channel fill, was that not a $2 million headwind last year?

Jim Graner

We had some operating expenses related to that particular store displays so I would say that there probably was not significant contribution into the profits last year.

Terry Darling - Goldman Sachs

OK, and then Pat, in terms of how you are thinking about organic for contractor Americas on a full year basis, I think if we make that channel fill adjustment again, I guess at $5 million, it would suggest you are up kind of 10% year-over-year. I think I heard you say though you are expecting single digits for the year.

Pat McHale

That's a worldwide number.

Terry Darling - Goldman Sachs

That's worldwide, OK. Can you maybe help us presumably looking for contractor Americas to be double digit then at this point?

Pat McHale

I think there is a chance.

Terry Darling - Goldman Sachs

And then shifting back over to the industrial side and trying to understand the year-over-year decline in percent segment margins there, I know there are a lot of moving pieces in there, but I am wondering if what we are really seeing there is the effect of the geographic mix and the translation is again Asia margins above segment average on a more normal basis which you are again dovetailing, Pat, in your comment about looking for margin improvement over the back part of the year. That just tied right in with a view that Asia comes back as well or are there other things going on?

Pat McHale

I think it's more of an issue for our development spending increase that we had and a little bit of pension flowing through a couple of different lines there. I think it's less related to mix. Our contractor mixes a bigger deal I think going from the US to Europe and Asia where they don't have the home centre business. Industrial business is good in Asia but I don't think that that slight difference in growth rate between the Americas and Asia-Pacific is the cause. I think it's more related to the investments we are making.

Terry Darling - Goldman Sachs

OK. Was there a product mix negative in the quarter as well that that might be influencing it too or no?

Pat McHale

No, not that I can out.

Terry Darling - Goldman Sachs

And the re-acceleration in Asia industrial growth, Pat, are you thinking that's more second half weighted or do you see enough on the order book or what have you to feel like you are going to see a bounce starting in the second quarter?

Pat McHale

Well, it's not clear. It's always easy to say the second half is going to be better, right. That's the standard line everybody used. I am not exactly right but based upon the comments that Jim gave you, again very short window to the first weeks of April here, it would appear that we may have seen bottom and that we are seeing some slight improvement of the bottom going into the second quarter here. I would like to see that trend continue the next couple of months and backup our thoughts with some good performance.

Terry Darling - Goldman Sachs

OK, and then just lastly in terms of how industrial is going to look in the second quarter relative to your comments, I guess we can imply that you have got $30 million or $32 million of powder revenues that come in as acquisition revenues. And then Pat, from a margin perspective I guess your comment that you'd expect sequential improvement there. Presumably that's though dampened down by the impact of the acquisitions which are coming in at a lower rate including all of the purchase accounting items and so forth. Is that - we have got those pieces right there?

Pat McHale

That's correct. My comments are related to the base business, the organic growth.

Terry Darling - Goldman Sachs

Thanks very much.

ACT Operator

We have a follow up a question from Charles Brady of BMO Capital Market. Please go ahead, sir.

Charles Brady – BMO Capital Markets

With regard to the contractor segment, are there any product fill opportunities in 12 that you are looking at or is this just kind of purely straight on business, existing business growth?

Pat McHale

I don't want to get too specific but we do have a couple of products that are going to launch yet here in 2012 that we are optimistic about.

Charles Brady – BMO Capital Markets

Will that be second half?

Jim Graner

Yes.

Charles Brady – BMO Capital Markets

Thanks.

ACT Operator

Thank you. We have no further questions.

Pat McHale

All right. Thank you very much for your time today, gentlemen.

ACT Operator

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

END OF CONFERENCE